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ECONOMIC OUTLOOK

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EXPANSION TO CONTINUE, BUT POLICY RISKS ABOUND

by
Richard W. Rahn and Graciela Testa-Ortiz

This month's issue of the ECONOMIC OUTLOOK is devoted to the Chamber's annual analysis of the prospects for U.S. industry. In keeping with recent concerns regarding the impact of foreign competition on U.S. industry, the industrial outlook details how some industries have met this challenge, and provides a forecast of industrial production, and employment for 1986.

Our expectations for the future of American industry, as well as the U.S. economy as a whole, are for a rebound in growth in 1986 and 1987 relative to this year's experience. The evidence for the third quarter—a rate of growth in real GNP of 3.3 percent on an annual basis—shows that the economy broke out of the plateau it had reached during the first half of the year and advanced at a modest rate.

In looking back on 1985, the most striking characteristic of the year was the damage wrought by the weakness in the nation's international trade position. Real net exports in 1985 are anticipated to show a $33 billion deficit ($91 billion in nominal terms) brought about by a 4.3 percent decline in exports and a 7.5 percent rise in imports. The other components of total gross national product are expected to post growth rates below those achieved in 1984. While this is to be expected, given that the recovery is already into its fourth year, the slowdown in the rate of growth of investment is particularly disappointing, although not entirely surprising given the uncertainty that has pervaded the fiscal policy process.

Consumer Spending: Car Sales and Housing

The third quarter surge in spending for automobiles, which contributed to a 20.6 percent increase in spending for consumer durables, will not be repeated during the year's last quarter. Domestic car sales, which averaged 9.4 million units during the third quarter, have already slowed significantly, averaging only 6.3 million units in October. We expect sales of domestic autos to average 7.2 million units in the final quarter, substantially below the 8.4 million rate of production which manufacturers have scheduled. As a result, real consumer spending during the fourth quarter should rise by only 2.2 percent compared to 5.2 percent in the first quarter and 4.8 percent in the two middle quarters of the year. However, despite what may, at first light, appear to be disturbing evidence stemming from the data on consumer indebtedness, we do not believe that a serious retrenchment in consumer spending is in the works.

A recent study by the Federal Reserve Bank of Kansas City notes that while household debt has risen rapidly during the current recovery, the ratios of liabilities to total assets and to total financial assets have remained fairly stable, implying that the net worth of households has risen (see Chart 1). Further, the ratio of liabilities to liquid assets does not show a significant increase in illiquidity. Although the ratio of debt to income continues to reach new highs, it exaggerates the burden of debt on American households for two main reasons. One is the increased substitution of credit cards for checks. Surveys show that as much as *half* of the users of bank credit cards pay their bills in full every month. Estimates place the overstatement on the debt/income ratio resulting from the convenience use of credit cards to be about one percentage point since 1977. Another factor which tends to place an upward bias on this ratio is the increase in the average maturity of consumer loans. Assuming that households consider monthly payments relative to income as the critical factor in determining how much they will borrow, longer maturities encourage higher levels of debt since they result in lower monthly payments.

IN THIS ISSUE

Expansion to Continue, but Policy Risks Abound......p. 1
Forecast Table......p. 4
Industrial Outlook......p. 5
Trends in Commerce......p. 18

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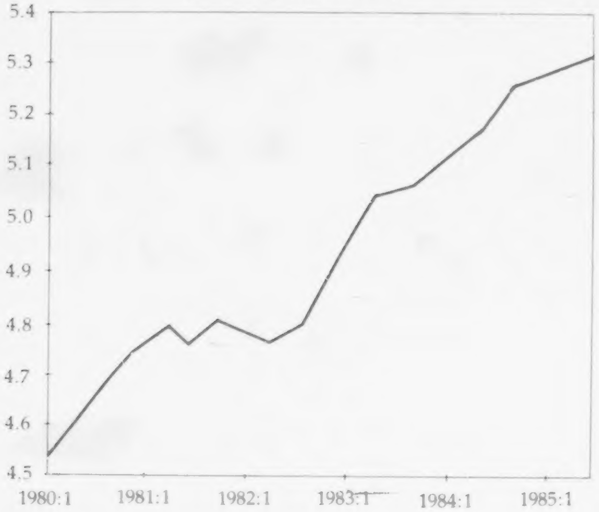
CHART 1
HOUSEHOLD NET WORTH
(billions of 1972 dollars)



Finally, demographic trends also come into consideration. The life-cycle theory of consumer behavior tells us that younger households tend to borrow heavily to purchase homes and other consumer durables. As the proportion of the population in the 25 to 44 age bracket rose to 30.4 percent in 1984 from 24 percent in 1970, so did household indebtedness.

Moreover, other indicators of consumer spending, such as employment growth and consumer confidence, continue to point in a positive direction. Total employment as measured by the household survey now stands at 108 million, having surpassed the previous cyclical peak of 100.7 million reached in July 1981 by 7.1 percent. The latest survey of consumer confidence shows that 88.9 percent of respondents expect the economy to remain strong. In view of these considerations, we expect real consumer spending to continue to boost the economy, rising by 4.2 percent this year and 3.6 percent in 1986.

The performance of the housing market during the past few months remains a puzzle. Since the beginning of this decade, housing starts have typically exceeded permits by an average of 7 percent. During September, however, starts stood 12 percent below the level of permits. Moreover, the departure from historical patterns is not restricted to a particular type of housing unit; it has occurred in all housing classes, single- as well as multifamily. At the same time, average mortgage commitment rates have fallen by 90 basis points between the first and third quarters of this year, and increases in new home prices have been quite modest. The lack of a significant increase in housing starts in the face of improved affordability and a high level of housing permits issued may be an indication that both home buyers and builders anticipate further slides in mortgage interest rates and will enter the market when that occurs. This month's forecast expects new housing starts to reach 1.75 million units during the first quarter of next year. As average mortgage rates slip below 11 percent, housing starts should average 1.86 million units by the first quarter of 1987.

Foreign Sector

A steady decline in the rate of growth of imports has become evident as U.S. economic activity settles into a more moderate rate of growth and demand for imports subsides. However, the problem in the foreign trade sector remains the poor performance of real exports, which rose a meager 4.7 percent in 1984 and are expected to decline by 4.2 percent this year. The latest data corroborates the dismal performance of U.S. exports. The merchandise trade deficit reached a record high of $15.5 billion in September. Although the series is highly volatile on a month-to-month basis, and the quarterly data show that the third quarter deficit was actually 5 percent lower than the second quarter level, the merchandise trade deficit is expected to reach an astonishing $124 billion for the year as a whole. The extent of the problem is emphasized when net exports are excluded from overall GNP. Under this measure of domestic demand (GNP minus net exports), U.S. economic activity rose by 8.9 percent in 1984, compared to the 6.8 percent recorded increase, and is estimated to rise by 3.6 percent this year versus the 2.5 percent forecast.

While the dollar's appreciation since 1980 is only one of about half a dozen factors responsible for the trade deficit, most analysts agree that it has had a predominant influence. Inasmuch as we believe that the dollar will continue to slide in foreign exchange markets, as it has for most of this year, a turnaround in the trade deficit should become apparent during 1986. Thus, real exports are anticipated to rise by 7.3 percent in 1986 and 11.7 percent in 1987. U.S. merchandise exports, which will decline an estimated 0.9 percent this year, are expected to rebound in 1986, rising by 3.5 percent, largely on the strength of an 11 percent increase in exports of consumer goods and a 10.5 percent rise in exports of foods, feeds and beverages. Exports of automobiles are expected to rise by 6.5 percent, while exports of industrial supplies and materials increase by 3.1 percent. Import growth, on the other hand, is forecast to decelerate markedly. Merchandise imports, which are estimated to rise by 11 percent this year should decelerate to a 3.5 percent rate of increase next year. In particular, imports of capital goods, estimated to increase by 11 percent this year, should fall by almost 2 percent in 1986 (see Table 1).

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TABLE 1
REAL EXPORTS AND IMPORTS (NIA Basis)
1984–1986

	Billions of 1972 Dollars			Percent Change	
	1984(a)	1985(e)	1986(f)	1985(e)	1986(f)
Exports of Goods and Services	146.0	139.8	149.9	-4.3%	7.2%
Mechandise	82.1	81.3	84.1	-0.9%	3.5%
Foods, Feeds & Beverages	13.5	11.5	12.7	-14.8	10.5
Industrial Supplies & Materials	21.3	21.3	22.0	0.1	3.1
Capital Goods except Autos	27.2	27.5	27.1	1.3	-1.5
Autos	6.6	7.2	7.7	9.4	6.5
Consumer Goods	6.8	6.5	7.2	-4.7	11.1
Other	6.7	7.2	7.4	8.2	2.1
Services	64.0	58.5	65.8	-8.5%	12.5%
Factor Income	41.2	36.3	41.8	-12.0	15.3
Other	22.8	22.2	24.0	-2.3	7.9
Imports of Goods and Services	161.1	173.1	179.3	7.5%	3.6%
Mechandise	115.9	128.9	133.5	11.2%	3.6%
Foods, Feeds & Beverages	8.7	9.4	8.4	7.5	-9.9
Industrial Supplies & Materials	28.9	29.5	29.8	2.2	1.0
Capital Goods except Autos	30.7	34.1	33.6	11.3	-1.5
Autos	17.6	20.6	21.8	16.8	6.1
Consumer Goods	26.6	31.1	36.1	16.9	15.9
Other	3.4	4.2	3.8	22.7	-10.5
Services	45.1	44.3	45.8	-1.9%	3.5%
Factor Income	21.6	19.5	20.5	-9.5	5.0
Other	23.5	24.7	25.3	5.1	2.2

(a) Actual
(e) Estimate
(f) Forecast
Source: U.S. Chamber of Commerce, Forecast Section, using the DRI macro model.

The Investment Environment

Businesses invest to expand capacity, reduce costs, or produce new products. But with the capacity utilization rate in the manufacturing sector hovering at 80 percent, expansion of productive capacity would hardly seem a top priority. Even still, the nation's manufacturing capacity rose by 0.8 percent in the third quarter of this year, an increase of 2.4 percent over the previous year. Enhanced competitiveness and cost reduction are, however, a different matter. In spite of the improvement in American businesses' ability to compete internationally as a consequence of the decline in the value of the dollar, U.S. producers still need to increase efficiency and productivity in order to regain their previous dominance in world trade. In spite of the fact that consumer spending is anticipated to begin easing toward the end of next year, investment in producers' durable equipment should begin to pick up by the middle of next year as exports of goods and services surge.

The Inflation Outlook

The inflation trend remains one of moderate, but rising prices. The overall price level, as measured by the GNP deflator, is anticipated to rise by 3.7 percent this year, comparable to 1984's 3.8 percent increase, and decelerate to a 2.8 percent rate of growth in 1986 before rising in 1987. Major collective bargaining contracts signed in the first three quarters of this year showed the smallest average wage increases in the series' 23 years. However, while wages for most sectors have registered increases *below* 3 percent, pay increases in the manufacturing sector have been running slightly *above* 3 percent in 1984 and 1985. Overall, however, the inflationary pressure stemming from labor costs remains moderate. In addition to moderate wage increases, weak capital costs, low capacity utilization rates, modest food price increases, and declining energy prices will continue to place downward pressure on prices.

On the negative side, however, are two factors, which while not entirely overwhelming the influence of those mentioned above, will begin to exert an upward influence on domestic inflation. On the one hand is the rapid acceleration in the money supply which should soon translate into rising inflation. The second influence is the slide in the value of the U.S. dollar. Whereas the optimistic view on the impact of the dollar's decline on domestic inflation holds that, for both domestic and foreign producers, market shares will be an overriding consideration compared to maintaining profit margins, there is some evidence that this may not turn out the be case after all. This view holds that domestic and foreign producers will not increase prices substantially in response to the relative price shifts induced by the dollar's decline, as the former attempt to regain market shares, and the latter opt for sacrificing profit margins in an effort to maintain market shares. This may not be the outcome, however, particularly in the case of Japanese producers since the yen has already reached a five year high with respect to the dollar. For instance, the Sony Corporation has already announced price increases in the 5 to 7 percent range effective next year. More increases should follow as the dollar continues to fall.

The impact of the dollar's depreciation on domestic inflation is evidenced in the near term discrepancy between inflation as measured by the Consumer Price Index (CPI) and the implicit deflator for GNP. The CPI is anticipted to begin accelerating next year and average a 3.4 percent rate of increase in 1986 and 4.1 percent in 1987. The GNP deflator, on the other hand, should rise by only 2.8 percent and 3.7 percent, respectively. The explanation for this divergence lies in the fact that the CPI includes the cost of imported consumer goods, while the GNP deflator does not.

Risks to the Outlook

As has been the case for most of this year, the major risks to our scenario for continued expansion stem from

TABLE I
UNITED STATES ECONOMIC OUTLOOK 1984-1987
Prepared by the U.S. Chamber of Commerce
Percent change from previous period at a seasonally adjusted annual rate

	QUARTERS									YEARS			
	Actual			Forecast						Actual	Forecast		
GROSS NATIONAL PRODUCT	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	87:1	1984	1985	1986	1987
Real GNP	0.3	1.9	3.3	3.9	3.3	4.4	4.3	4.1	3.7	6.8	2.5	3.7	3.9
Consumption	5.2	4.8	4.8	2.4	4.0	3.7	3.3	2.2	2.4	5.3	4.2	3.6	2.7
Residential Investment	5.5	6.1	10.9	-1.5	6.5	9.8	9.3	6.8	2.6	12.2	2.1	6.5	3.2
Business Fixed Investment	-1.5	14.4	-4.6	0.7	4.3	5.0	7.2	6.6	4.6	19.8	6.0	3.7	6.0
Equipment	-5.6	16.6	-3.5	0.2	4.1	5.3	8.8	7.9	5.3	21.5	5.4	4.1	6.7
Structures	9.5	9.2	-7.7	2.3	5.1	4.3	3.0	3.2	2.7	15.6	7.7	2.6	4.2
Exports	-8.9	-15.2	0.6	4.1	8.0	12.1	17.9	17.3	7.7	4.7	-4.3	7.2	11.9
Real Net Exports (72$B)	-28.4	-33.8	-34.0	-37.0	-35.5	-32.7	-27.7	-21.5	-18.3	-15.0	-33.3	-29.4	-11.6
Imports	32.2	-0.7	0.7	10.6	2.8	3.1	2.5	0.1	-0.4	27.0	7.5	3.6	0.1
Government Purchases	0.6	-0.3	33.4	-11.3	-13.4	-1.6	-1.3	1.3	1.6	3.5	9.0	-2.6	1.2
Real Final Sales	-0.3	4.6	5.9	0.1	2.8	4.1	4.6	4.2	3.2	5.0	3.5	3.3	3.9
Industrial Production	2.1	1.3	1.2	2.5	2.5	4.0	5.9	3.3	3.2	10.6	2.2	3.0	4.3
Change in Business Inventories (72$B)	19.1	8.3	-2.1	13.8	16.3	17.5	16.3	16.4	18.6	24.8	9.8	16.6	16.9
New Car Sales (total, mill.)	11.3	11.5	12.5	10.6	10.9	11.5	12.0	11.5	11.6	10.5	11.2	11.5	11.6
New Domestic Car Sales (mill.)	8.5	8.2	9.4	7.2	8.0	8.2	8.5	7.9	7.9	8.0	8.3	8.2	7.8
New Housing Starts (total, mill.)	1.8	1.8	1.7	1.7	1.7	1.8	1.9	1.9	1.9	1.8	1.7	1.8	1.9
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	7.3	7.3	7.1	7.1	7.1	7.0	6.9	6.7	6.7	7.5	7.2	6.9	6.6
Compensation	5.0	3.3	1.8	3.4	4.3	4.3	4.5	4.8	5.3	4.2	3.7	3.8	4.9
Productivity	-3.3	1.1	1.1	1.4	1.4	1.2	1.7	1.1	-0.2	2.7	0.2	1.3	1.2
Unit Labor Costs	8.5	2.2	0.5	2.1	2.8	3.1	2.7	3.7	5.4	1.4	3.4	2.5	3.7
Consumer Price Index	3.3	4.2	2.4	2.8	3.5	3.9	3.3	4.2	4.2	4.3	3.4	3.4	4.1
Implicit GNP Deflator	5.4	2.6	3.3	3.2	2.6	2.4	2.8	3.3	4.5	3.8	3.7	2.8	3.7
Prime Interest Rate (%)	10.5	10.2	9.5	9.5	9.4	9.1	8.9	8.8	8.4	12.0	9.9	9.0	8.9
3-mos. Treasury Bill Rate (%)	8.2	7.5	7.1	7.2	7.0	6.5	6.2	6.0	5.7	9.5	7.5	6.4	6.2
Corporate Bond Rate (%)	12.3	11.6	11.0	11.0	10.7	10.4	10.1	9.8	9.5	12.7	11.5	10.2	9.5
Real Personal Disposable Income	-1.6	8.2	-4.1	3.1	3.0	3.4	3.2	2.5	4.9	6.7	2.3	2.5	3.3
Profits from Current Production ($B)[1]	207.0	214.9	224.0	227.1	221.5	221.7	225.3	222.7	214.0	195.9	217.5	222.8	218.8
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts										666	733	790	860
Unified Outlays										842	933	980	1045
Unified Deficit										-176	-200	-190	-185

[1] After-tax corporate profits with inventory valuation and capital consumption adjustments.

[2] Unified budget figures on a fiscal year basis. 1985 data are actuals.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Data Resources, Inc. model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's revision to the National Income and Product Accounts for the third quarter of 1985. It continues to take into account all the provisions of previously enacted legislation, including indexation of personal income tax rates. Congress is assumed to enact a deficit reduction package which results in a static reduction in federal government outlays of $36 billion in 1986 and $64 billion in 1987. The nation's money supply, as measured by M(1), rises by almost 9 percent in 1985, 8 percent in 1986 and 7 percent in 1987. The federal minimum wage remains at $3.35 per hour throughout the forecast interval. The price of a barrel of imported crude oil averages $25 in 1986 and $24 in 1987 compared to $28.9 in 1984. The trade-weighted exchange value of the dollar rises 3.3 percent this year on a year-over-year basis. During 1986 and 1987, it falls by 19 percent and 7 percent, respectively.

fiscal policy considerations. In particular, the tax reform process, which is becoming increasingly hostile to capital formation, has increased business uncertainty and affected investment decisions. A recent survey of a cross-section of the Chamber's medium and large business member shows that 41 percent of those queried have changed their investment plans as a result of the uncertainty caused by the pending tax reform bill.

Past issues of ECONOMIC OUTLOOK have detailed the likely impact of tax reform on the nation's economy, particularly with respect to its effect on capital costs and business investment. As it now stands, the latest version of the tax reform bill, the House Ways and Means Committee's staff options, will worsen the competitive position of U.S. exports by sharply increasing domestic capital costs and reducing U.S. investment and productivity growth. This will partially offset the improvements in U.S. competitiveness stemming from the dollar's depreciation. Estimates place the decline in real exports resulting from the House Ways and Means proposal at a cumulative $13 billion between 1986 and 1990 from what would otherwise occur.

To the threat of tax reform must be added the increasing pressures for protectionist legislation by various American industries. There are now approximately 300 pieces of legislation before the Congress, all of which would, in one way or another, effectively close U.S. markets to foreign goods. Econometric studies of general types of protectionist measures, such as an import surcharge, show that such legislation would have no long-term impact on the current account deficit. Such a move would, however, likely result in a serious inflationary shock as the price of both domestically produced and imported goods rise. For instance, estimates place the average increase in the price of automobiles resulting from the voluntary restraints on car imports, at $1,400 for imported cars and $600 for domestic autos. Protectionist pressures should be steadfastly resisted, particularly in light of the fact that the continued decline in the dollar's value, along with further real rates of economic growth among America's trading partners, will go a long way toward correcting the nation's trade imbalance.

INDUSTRIAL OUTLOOK

by

Rajni Bonnie Ohri and Graciela Testa-Ortiz

U.S. industry has embarked on a process of adjustment to rapidly changing global economic conditions. This process of industrial restructuring is accompanied by a host of social and economic problems brought about by the shedding or shrinking of employment and output in older, more mature industries, and increases in newer, more dynamic sectors. This process is by no means a negative development, on the contrary, it is a sign of economic strength. An economy that can adjust successfully to changing technology, consumer tastes, and global economic conditions is a healthy, growing economy whose industries can compete effectively both at home and abroad.

Since the beginning of the decade, manufacturing output has risen at an average annual rate of 3.1 percent (see Tables 1 and 2). However, despite this overall improvement, the industry detail paints a very grim picture as a large number of industries have stagnated or suffered declines in output. This performance results from the fact that the data includes the twin recessions of 1980 and 1982. Since it was the recessions which prompted many of the adjustments now underway, these data do not accurately portray the strengths and weaknesses of American industries. The second column in Tables 1 and 2, showing industrial production growth since the end of the 1982 recession, gives a better indication of recent industrial performance. From it we can isolate and explain the factors affecting industrial activity.

TABLE 1
THE PERFORMANCE OF AMERICA'S INDUSTRIES
Market Groups
(average annual growth rates)

	1980-1985	1982-1985
Total Industry	2.7%	6.7%
Total Products	3.3	6.8
Final Products	3.1	6.3
Consumer Goods	2.6	5.1
Business Equipment	1.8	6.5
Farm Equipment	-10.4	-8.7
Defense & Space Equipment	10.3	12.0
Intermediate Products	3.8	8.7
Materials	1.8	6.7

Source: U.S. Chamber of Commerce, Forecasting Section using the DRI macro model.

The factors shaping the character of American industry are several and vary from industry to industry. For instance, many of the industries which enjoyed above average increases in output benefited from improvements in the housing and automobile markets, major sources of demand for sectors such as lumber, furniture and fixtures, stone, clay and glass, fabricated metals, and rubber and plastics. At the other extreme, some of the industries which suffered weak output growth or continued declines in production despite the recovery, face problems unique to their sectors. The farm equipment and agricultural chemicals sectors have felt the full impact of the problems facing American agriculture. Petroleum products, and oil and gas extraction have suffered from the slide in the world price of oil, declining demand for this source of energy, and oversupply of petroleum. The decline in the fortunes of the tobacco industry is related to a shift in demand due to changed consumer tastes and health concerns.

TABLE 2
THE PERFORMANCE OF AMERICA'S INDUSTRIES
Manufacturing Sector
(average annual growth rates)

	1980–1985	1982–1985
All Manufacturing	3.1%	7.7%
Nondurable Manufacturing	2.8	5.9
Food & Products	2.6	4.0
Tobacco	-1.7	-2.3
Textile Mill Products	-0.5	2.9
Apparel	0.0	5.5
Paper & Products	3.4	5.7
Printing & Publishing	5.8	8.3
Chemicals & Products	3.0	7.1
Agricultural Chemicals	-1.7	0.4
Basic Chemicals	0.2	6.7
Synthetic Materials	6.4	13.3
Drugs & Medicines	4.3	3.9
Soaps & Toiletries	4.0	6.5
Petroleum Products	-1.8	-0.2
Rubber & Products	6.4	10.8
Tires	6.8	5.6
Other Rubber Products	2.0	6.6
Plastics Products	7.3	12.5
Leather & Products	-4.0	-2.7
Durables	3.3	9.2
Lumber	5.7	12.1
Furniture & Fixtures	6.6	10.3
Household Furniture	4.6	8.0
Stone, Clay & Glass	2.6	10.0
Glass & Glass Products	0.1	3.4
Cement & Structural Clay	2.9	14.1
Primary Metals	-2.0	7.4
Basic Steel Products	-3.2	9.1
Iron & Steel	-3.6	7.8
Nonferrous Metals	0.5	7.5
Fabricated Metal Products	1.7	8.8
Metal Cans	-1.3	1.8
Nonelectrical Machinery	3.0	8.6
Engines & Turbines	-2.6	2.2
Engines & Farm Equipment	-6.1	-2.2
Construction Equipment	-1.7	5.1
Metalworking Machinery	0.5	7.4
Industrial Equipment	0.4	8.3
Office Equipment	10.0	12.8
Electrical Machinery	4.7	8.7
Major Electrical Equipment	-3.1	0.8
Household Appliances	3.0	10.4
Television & Radio Sets	-0.2	4.6
Communication Equipment	9.0	11.5
Electronic Components	7.0	10.7
Transportation Equipment	5.5	13.8
Motor Vehicles & Trailers	9.5	19.8
Autos	8.6	23.1
Motor Vehicle Parts	7.1	14.3
Trucks, Buses & Trailers	20.6	30.5
Aircraft & Parts	1.9	6.1
Railroad Equipment	-15.1	-0.5
Instruments	0.9	3.5
Equipment Instruments	2.8	5.8
Consumer Instruments	-1.2	0.8
Miscellaneous Manufactuers	0.2	3.1

Source: U.S. Chamber of Commerce, Forecasting Section using the DRI macro model.

However, excluding these factors, two major changes in the economic environment have had a significant impact on industry performance. These are: (1) the impact of innovation and new technologies in industrial processes which has resulted in a shift away from mechanical industries and metal-based materials towards microelectronics and synthetics, respectively; and (2) increased competition from foreign producers in domestic markets. These two developments account for the performance of some sectors whose recovery experience cannot be entirely explained by the effects of the cyclical upturn or industry-specific developments.

Apart from the industries already mentioned, other sectors (including electronic components, communications equipment, office and computing machines, and plastics), have experienced dramatic improvements. In contrast, industries such as leather products, engines and turbines, glass products, metal cans, and television and radio sets, have remained weak or experienced declines in manufacturing output. The first group of industries has benefited directly from the shifts resulting from innovation and improved technology. For instance, plastic containers are being increasingly substituted for glass and metal containers in packaging. The sharp rise in foreign competition, accounts for the dismal performance of sectors such as leather and television and radio sets, where 1984 import penetration ratios are 47 percent and 59 percent, respectively.

For the economy as a whole, real imports as a share of domestic goods purchased have increased from 11.5 percent in 1980 to 15 percent in 1985. Table 3 shows the import penetration ratios in the nation's manufacturing industries. For broad categories of the nondurables goods industries (i.e., two digit SIC classification), the market share of imports accounts for less than 10 percent in every industry with the exception of apparel and leather. Broad categories of durable goods producers (two digit SIC codes), face a higher level of competition than their counterparts in the nondurable sector, however, with the exception of miscellaneous manufacturing, the share of imports in domestic markets is less than 20 percent. percent.

Comparing Tables 1, 2 and 3, it is interesting to note that there is no discernible pattern between the extent of import penetration and the performance of domestic output. Some industries have enjoyed significant improvements in output, while others have done quite poorly. For instance, the U.S. apparel industry, where imports comprise 25 percent of the domestic market, enjoyed an average annual increase in output of 5.5 percent, slightly above the rate of growth in output of the consumer goods sector as a whole. On the other hand, the instruments industry with an import penetration ratio of 14 percent saw output increase by only 3.5 percent.

TABLE 3
U.S. IMPORT PENETRATION*
(percent)

INDUSTRY	1981	1984
Nondurables		
Food & Products	4.2%	4.0%
Tobacco	2.0	0.5
Textile Mill Products	6.0	7.0
Apparel	13.7	25.0
Paper & Products	6.4	8.5
Printing & Publishing	1.0	1.0
Chemicals & Products	4.4	6.9
Basic Chemicals	21.0	21.0
Petroleum Products	6.8	9.9
Rubber & Products	7.7	9.0
Leather & Products	24.7	47.0
Leather Shoes	33.0	51.0
Luggage & Personal Goods	38.7(a)	52.4
Durables		
Lumber & Wood Products	5.7	8.0
Wood Furniture	4.8	7.0
Stone, Clay, Glass	5.1	7.3
Nonferrous Metals	14.5	16.0
Fabricated Metals	3.9	5.0
Steel Mill Products	19.0	22.0
Nonelectrical Machinery	8.0	14.0
Machine Tools	27.0	31.0
Foundry Equipment	8.4(a)	17.2
Construction Machinery	9.0	12.0
Paper Industries Machinery	15.0(a)	17.0
Farm Machinery	13.0	17.0
Textile Machinery	39.3(a)	45.7
Oil Field Machinery	4.0	1.0
Compressors	9.0	12.0
Pumps	9.0	7.0
Internal Combustion Engines	6.0	5.0
Computers	7.0	19.0
Electrical Machinery	12.4	18.0
Transformers	6.0	10.0
Motors & Generators	10.0	13.0
Semiconductors	34.0	39.0
Radios & T.V. Sets	59.0	59.0
Household Appliances	9.0	13.0
Transportation Equipment	14.8	17.0
Motor Vehicles	19.0	16.0
Passenger Car Units	27.0	25.0
Civilian Aircraft	22.0	29.0
Other Aircraft Equipment	18.0	20.0
Instruments	11.3	14.0
Engineering & Optical Inst.	19.0	16.0
Measuring & Control Inst.	5.2	5.0
Electricity Measuring Inst.	12.0	11.0
Miscellaneous Manufactures	23.6	27.0

*Imports as a share of apparent consumption.
(a) Indicates 1982 data
Source: U.S. Chamber of Commerce

Although most major categories of American industries face import penetration ratios of 20 percent or less, a majority of them have experienced an increase in the proportion of domestic demand satisfied by foreign producers. Moreover, in important categories within the broad industry classifications, imports account for a major share of the domestic market. For instance, the ratio of imports in the machine tools industry is 31 percent, even though for the nonelectrical machinery industry as a whole, it only reaches 14 percent. At the same time, however, two industries in which foreign producers have made significant inroads into domestic markets – basic chemicals, and television and radio sets – have not experienced further increases in the import penetration ratio since 1981.

The remainder of this article will discuss how particular U.S. industries have faced these challenges and present our forecast for employment and output in 1986.

Industrial Production and Employment

The outlook for U.S. industrial production and employment is for a resumption in growth following the lull in activity during the first half of this year. Following the explosive 10.5 percent increase in total industrial production during 1984, this indicator of industrial health is estimated to post only a 2.2 percent increase this year, rebounding modestly in 1986 to 3 percent (see Tables 4 and 5).

TABLE 4
INDUSTRIAL PRODUCTION BY INDUSTRY
Market Groups
1984–1986
(rates of growth)

	1984(a)	1985(e)	1985(f)
Total Industry	10.5%	2.2%	3.0%
Total Products	10.6	3.6	3.1
Final Products	10.6	3.3	3.3
Consumer Goods	6.5	1.8	2.6
Business Equipment	17.3	4.8	1.8
Farm Equipment	2.8	-17.2	-1.9
Defense & Space Equipment	13.1	9.7	8.2
Intermediate Products	10.7	4.3	2.7
Materials	10.7	.0	2.9

(a) Actual
(b) Estimate
(f) Forecast
Source: U.S. Chamber of Commerce, Forecasting Section, using DRI macro model of the U.S. economy.

By market groupings, the strongest performer this year and next is expected to be the defense and space equipment sector. Production of business equipment will rank second in 1985, but by 1986 it will lose its position to consumer goods production. Not surprisingly, the weakest sector is farm equipment where industrial production will fall by 17 percent this year and continue to slide in 1986. There will be no recovery in this sector until American agriculture recovers.

By industry group, both nondurable and durable manufacturing will show increases in industrial output higher than the total for all U.S. industry in 1985, with the durable sector performing slightly better than nondurables. Within durable manufacturing, the output of

TABLE 5

INDUSTRIAL PRODUCTION BY INDUSTRY
Industry Groups
1984–1986
(rates of growth)

	1984(a)	1985(e)	1985(f)
Manufacturing	11.3%	2.5%	3.2%
Primary Processing Industries	9.3	2.1	5.4
Advanced Processing Industries	12.6	2.7	2.1
Nondurables	6.8	2.4	4.9
Food & Products	4.6	3.4	4.3
Tobacco	1.8	-4.3	1.2
Textiles	-2.0	-2.0	6.1
Apparel	8.8	-1.8	0.4
Paper & Products	7.3	0.2	3.2
Printing & Publishing	12.7	4.9	5.4
Chemicals & Products	6.1	4.4	6.4
Basic Chemicals	6.1	1.7	6.4
Synthetic Materials	9.9	6.9	10.3
Agricultural Chemicals	12.1	-4.6	-6.3
Petroleum Products	1.4	-0.8	2.9
Rubber & Products	12.9	2.3	6.1
Tires	11.2	-5.1	4.0
Leather & Products	-3.8	-6.1	-7.5
Durables	15.2	2.6	2.0
Lumber	8.2	3.5	5.3
Furniture & Fixtures	13.0	3.4	1.1
Stone, Clay & Glass	13.4	2.8	3.3
Glass & Products	8.0	-0.4	2.5
Cement & Structural Clay	15.0	6.9	0.7
Primary Metals	10.1	-2.5	7.1
Basic Steel & Mill Products	12.3	-3.9	7.5
Iron & Steel	11.0	-4.8	7.5
Nonferrous Metals	10.8	0.3	6.0
Fabricated Metal Products	14.5	5.5	4.2
Nonelectrical Machinery	20.3	3.4	1.1
Construction & Allied Equip.	28.6	7.5	1.3
Metalworking Machinery	22.6	3.9	0.4
General Industrial Equipment	20.1	1.2	-0.9
Office & Misc. Equipment	21.4	4.6	2.4
Electrical Machinery	18.4	-2.8	-3.1
Major Elect. Equipment & Parts	12.5	-8.7	1.6
Electronic Components	29.1	-10.5	-7.9
Household Appliances	15.9	-1.5	-2.9
Communication Equipment	16.3	8.7	1.4
Television & Radio Sets	18.3	-16.5	-27.6
Transportation Equipment	16.1	8.4	4.3
Autos	12.9	9.8	2.0
Motor Vehicle Parts	18.5	3.2	1.5
Trucks, Buses & Truck Trailers	37.2	9.7	9.2
Aircraft and Parts	7.9	11.6	9.5
Railroad Equipment	83.2	8.6	28.5
Instruments	9.6	2.8	2.3
Equipment Instruments & Parts	11.1	2.9	2.0
Consumer Instruments	9.0	2.5	2.6
Miscellaneous Manufactuers	3.6	-0.7	2.1
Utilities	3.6	2.4	1.3
Mining	7.6	-1.5	-0.5
Mining except Oil & Gas	14.3	-0.7	1.3
Oil & Gas Extraction	4.6	-1.9	-1.3

(a) Actual (b) Estimate (f) Forecast

Source: U.S. Chamber of Commerce, Forecasting Section, using DRI macro model of the U.S. economy.

transportation equipment will increase an impressive 8.4 percent in 1985 on the strength of automobile production. Next year, however, the nondurable manufacturing sector is expected to take the lead rising by 4.9 percent compared to a 3.2 percent projected increase for manufacturing as a whole, and a lackluster 2 percent rise in industrial production of durables.

Reflecting the growing economy, total nonfarm employment, which is estimated to have risen by 3.2 million jobs in 1985, should increase by an additional 2.5 million jobs in 1986 (see Table 6). The strongest source of new jobs in

TABLE 6

EMPLOYMENT BY INDUSTRY
1984–1986
(millions)

	1984(a)	1985(e)	1986(f)	Percent Change (86 over 85)
Nonfarm, total	94.45	97.64	100.17	2.6%
Manufacturing	19.41	19.41	19.49	0.4
Nondurables	7.89	7.85	7.91	0.7
Food & Products	1.62	1.63	1.64	0.5
Tobacco	0.06	0.06	0.06	-5.7
Textiles	0.75	0.70	0.71	1.2
Apparel	1.20	1.16	1.13	-2.3
Paper & Products	0.68	0.68	0.69	1.4
Printing & Publishing	1.37	1.42	1.46	3.0
Chemicals & Products	1.05	1.04	1.05	0.8
Petroleum Products	0.19	0.18	0.18	-0.2
Rubber & Products	0.78	0.79	0.80	1.3
Leather & Products	0.19	0.18	0.17	-2.0
Durables	11.52	11.56	11.58	0.2
Lumber & Wood Products	0.71	0.70	0.73	3.6
Furniture & Fixtures	0.49	0.50	0.52	3.7
Stone, Clay & Glass	0.60	0.60	0.61	1.7
Primary Metals	0.86	0.81	0.81	0.1
Fabricated Metals	1.46	1.47	1.50	1.8
Nonelectrical Machinery	2.20	2.18	2.14	-1.9
Electrical Machinery	2.21	2.20	2.11	-4.3
Transportation Equipment	1.91	1.99	2.06	3.3
Instruments	0.71	0.72	0.73	1.4
Miscellaneous Manufactures	0.38	0.38	0.37	-0.8
Mining	0.97	0.97	0.92	-4.5
Contract Construction	4.34	4.65	4.86	4.4
Finance, Insurance & Real Estate	5.68	5.92	6.24	5.2
Transportation & Public Utilities	22.13	23.20	23.99	3.4
Wholesale & Retail Trade	20.76	21.91	22.79	4.0
Services	20.76	21.92	22.77	3.9

(a) Actual
(e) Estimate
(f) Forecase

Source: U.S. Chamber of Commerce, Forecast Center, using the DRI macro model.

1986 is anticipated to be the finance, insurance and real estate industry where 1986 employment is forecast to increase by 5.2 percent, twice as fast as total nonfarm employment. Wholesale and retail trade, and construction employment should rise by 4 percent and 4.4 percent, respectively, while manufacturing employment is projected to increase only slightly.

Of particular interest to our discussion of the impact of foreign competition on American industry is the performance of industry export and imports shown in Table 7. While the surge in imports during 1984 is undeniable, note that total exports for the industries listed in Table 7, also increased an impressive 11.2 percent following an almost 3 percent decline in 1983. The 1985 pattern of exports and imports for these industries reflects the general trend discussed in the previous article, exports are estimate to post a 2.4 percent decline while import growth subsides.

TABLE 7

EXPORTS AND IMPORTS BY INDUSTRY

(percent change)

	Exports			Imports		
Industry	**1983**	**1984**	**1985(a)**	**1983**	**1984**	**1985(a)**
Food & Products	-0.5%	0.4%	-12.5%	7.9%	16.4%	5.7%
Tobacco	-8.9	-0.6	6.9	14.9	8.3	-6.3
Textile Mill Products	-11.7	-1.2	-4.9	14.7	37.4	-1.8
Apparel	-12.4	-4.4	-5.7	17.6	39.7	8.3
Wood Furniture	-0.4	-5.4	-3.2	44.6	9.3	4.8
Paper & Products	-2.5	5.3	-9.2	6.3	30.9	3.0
Printing & Publishing	-2.6	4.2	-7.3	18.2	34.6	4.7
Chemicals & Products	-1.6	15.0	-1.8	23.1	28.2	5.3
Industrial Chemicals	-0.3	13.4	-2.9	19.5	25.2	7.2
Agricultural Chemicals	-16.6	19.2	0.0	19.4	25.0	-13.8
Crude Petroleum & Natural Gas	-35.4	-8.9	-1.6	-18.8	-1.7	-14.5
Rubber & Products	1.5	5.8	-5.4	75.0	44.5	5.4
Leather Tanning	-9.7	24.0	-2.4	-6.2	35.1	-5.4
Leather Footwear	-11.4	9.5	9.3	19.2	27.2	8.4
Construction Materials	-27.6	-14.2	15.8	42.3	75.8	55.4
Construction Machinery	-30.2	2.6	0.1	-16.3	70.7	31.9
Metalworking Machinery	-24.9	4.4	10.9	-28.2	50.8	24.4
Electronic Components	6.5	19.1	-11.8	19.8	50.6	3.1
Industrial Electronic Equipment	-24.3	-1.2	-7.7	18.6	38.4	13.3
Computers	16.0	28.0	12.7	na	na	na
Motor Vehicles	25.6	16.1	23.3	18.1	27.2	17.8
Instruments	4.2	2.6	20.4	7.1	36.8	15.7
TOTAL	-2.6	11.2	-2.4	3.0	20.7	4.0

(a) Data for 1985 is only available through the month of August. To calculate the rate of growth for 1985 the value of exports and imports for the first eight months of the year were compared to the same period in 1984.

na not available

Source: U.S. Department of Commerce.

In spite of the projected 1985 decline in total exports, four industries – construction materials, metalworking machinery, motor vehicles, and instruments – will actually enjoy substantial improvements in exports. Moreover, none of the industries listed is anticipated to experienced continued increases in the rate of growth of imports in 1985 compared to 1984. And, in fact, five industries (crude petroleum, tobacco, textiles, agricultural chemicals, and leather tanning), included among them those that have shown no improvement or a continued deterioration in industrial production during the recovery, will show actual declines in imports this year.

One case – leather footwear – merits particular attention because of the strident calls for import protection which have come from the industry. Although the import penetration ratio rose from 33 percent in 1981 to 51 percent last year, imports of leather shoes slowed significantly in 1985, rising by 8.4 percent compared to 27 percent in 1984. Moreover, exports of U.S. leather footwear rose by 9.5 percent in 1984 and are estimated to increase a further 9.3 percent this year. This industry is one of only five industries among the 23 listed which will actually experience an increase in exports during 1985.

Protectionism on the Rise

As the discussion of each particular industry that follows explains, American industries are meeting the twin challenges of technological change and foreign competition, and have gone a long way towards restructuring. In some cases, industry analysts have noted that further improvements are still called for. Nevertheless, there are now before Congress 300 pieces of legislation designed to increase protection and restrict market access to foreign producers.

Protectionism is not a solution. Its costs are tremendous, even assuming no retaliation by our trading partners. Increased protection would result in higher domestic prices and reduced consumer choice, lowering the standard of living of all Americans. The cost to American consumers and taxpayers are quite real. Some estimates have placed the cost of existing protectionist legislation at between $1,500 and $2,000 per year for the average American family. As a result of existing legislation, U.S. consumers paid an additional $4.5 billion for autos, $1 billion for footwear, $3 billion for sugar, and $18.4 billion for apparel and textiles in 1984.

Protectionism has other negative implications. Competitive pressures have forced U.S. industries to lower production costs and increase productivity, thus becoming more efficient. This would not have occurred behind protective barriers. Finally, closing our markets to foreign goods will boomerang against us even under the unlikely event that foreigners do not retaliate. As U.S. demand for imports declines, so would U.S. exports, since foreign economies, faced with a shrinking export market, would experience declines in economic activity and concomitant reductions in their demand for imports, including U.S. products.

INDUSTRY DETAIL

Construction

The construction sector is expected to continue to show fairly strong growth in 1986, albeit down some from the robust pace of the last two years. Residential investment is expected to rise by 6.5 percent next year while investment in nonresidential structures rises by only 2.6 percent as growth in office and commercial construction slows. Construction of retail facilities, because it is linked closely to homebuilding, will continue strong next year as new housing starts average 1.8 million units. Employment in the construction industry should increase by 4.4 percent in 1986. Despite the recent moderation in wage increases, construction has remained one of the highest paying industries as measured by average hourly earnings. Aided by belt-tightening measures taken last year, home builders' profits are expected to increase in 1986.

Real investment in private nonresidential construction is estimated to show a sharp 7.7 percent gain in 1985, rising faster than overall GNP. The sector continues to benefit from strong growth in office and commercial building which has risen sharply despite high vacancy rates. Tax incentives seem to be the major force behind the strength of this sector. However, it is primed for a significant adjustment since office space has been overbuilt in many regions of the country. As this constitutes a significant proportion of nonresidential construction, the downturn in office buildings will have a large impact on total construction. Further, solid gains in roadbuilding and military construction put an end to the 15 year downturn on public works projects.

Declining interest rates and inflation, rising availability of funds, and confidence in the economy are important determinants of the strength and mix of construction activity in 1986. Probably more important, however, will be the outcome of the tax reform debate. Most of the tax reform proposals, particularly the latest House Ways and Means staff version of the bill, would significantly raise the rental cost of capital on residential building and, by some estimates, result in a 7.3 percent decline in construction activity next year from what would have occurred under present law.

Lumber and Wood Products

Nineteen eighty-five was a mediocre year for the U.S. lumber and wood products industry as investment in residential construction, a major source of demand for the industry, slowed from a 12 percent rate of growth in 1984 to an estimated 2.1 percent this year. Industrial output of lumber and wood products is estimated to rise by 3.5 percent this year, half the growth rate achieved in 1984. Similarly, industry employment remained virtually flat in 1985. Industry profits are anticipated to fall substantially this year because of lower prices for wood products, weakness in pulp markets, and competition from Canadian imports. Although there has been no significant increase in the industry's overall import penetration ratio, a growing proportion of U.S. demand is being met by Canadian imports. As a consequence, a serious confrontation over Canada's growing raw timber exports to the U.S. appears to be developing. By the end of this year, Canadian raw timber will represent 31 percent of U.S. consumption, double its share of a decade ago.

The industry has been successful in meeting the foreign challenge. In response to growing pressures form imports, both the Louisiana-Pacific Corporation and the Georgia-Pacific Corporation have responded with new products. This year, these two companies will significantly increase their production of low-cost substitutes for plywood—a sizeable market in which the Canadians do not compete aggressively. In addition, several companies, including International Paper, have installed modern machinery to improve productivity and output.

Although trade deficits in the industry have been common, the size of the deficit has grown substantially since 1980. This makes it vital for the industry to increase exports, particularly to regions of the world where the demand for wood products is growing more rapidly than the supply of available timber. Unfortunately, this potential increase in exports of U.S. lumber is limited by government regulations which ban the export of timber from federal lands.

Despite the fact that output in the durable goods sector is anticipated to slow further next year, lumber production is expected to increase as residential investment rises by 6.5 percent. As lumber output rises by 5.3 percent in 1986, industry employment is expected to increase by 3,000 jobs, or 3.6 percent.

Stone, Clay and Glass

As with the lumber industry, the fortunes of the stone, clay, and glass industry are also tied to residential construction activity and interest rates. The positive outlook for both interest rates and housing during 1986 points to a 3.3 percent increase in this industry's production, compared to a projected 2.8 percent rise in 1985. Consequently, industry employment should rise by 1.7 percent in 1986. Profits at most companies have picked up this year and will continue to improve in 1986.

Output of cement and structural clay products, used extensively in residential construction, is projected to grow by 7 percent this year, significantly faster than the industry average. While competition from imports is not a major problem for the industry as a whole, import pressures have been felt in some areas. For instance, imports of clay from Canada and Mexico have become a problem for U.S. producers serving border areas.

Following several years of deteriorating performance, output of glass containers is expected to grow moderately next year. An industry-wide restructuring has left producers in a much stronger position as nearly one-fourth of all glass melting capacity was eliminated between 1980 and 1984. Output of glass and glass products is expected to rise by 2.5 percent in 1986, following a projected 0.4 percent decline this year.

Nonferrous Metals

After almost no growth in 1985, rising demand in the automotive and capital goods industries should contribute to a 6 percent increase in nonferrous metal production in 1986. The industry, which includes producers of nickel, lead, zinc, copper, and aluminum, is still beset with problems that made the recent recession the worst period in their history. These include worldwide overcapacity, tough foreign competition (as measured by an overall import penetration ratio of 16 percent), falling prices, and a strong dollar.

Some metals are also undergoing special problems of their own which are independent of general business conditions. A case in point is lead. Lead producers have lost a big share of their market as a result of the elimination of the product from paint and gasoline. Copper is facing similar market losses. For the past decade, the intensity of copper use has been declining due to substitution, miniaturization, and automotive downsizing. For copper producers, 1986 earnings will be lower than this year's. In spite of the increase in copper demand (global consumption of copper was up a healthy 8 percent last year), domestic producers were forced to cut back production because global supply of copper still exceeds demand and prices remain depressed. Zinc is enjoying increasing usage in the automotive and construction markets, which account for 70 percent of all the zinc produced. Galvanizing will continue to be the single largest application for zinc, although competition from other protective coatings will intensify.

Industry officials do not expect any major increase in the demand for aluminum next year. In an effort to redress the current oversupply, major producers such as the Aluminum Company of America (Alcoa) and the Reynolds Metals Company announced the closing of selected potlines for producing primary aluminum. Domestic producers are instead, concentrating their efforts on developing more sophisticated aluminum products for use in everything from aircraft fuselages to computer chips. Increasingly, they favor producing primary aluminum at facilities abroad, where advantages such as inexpensive power, proximity to raw materials, and growing markets exist.

Iron and Steel

Although domestic demand for steel products increased by 6 percent this year, production fell by 4.8 percent, largely as a result of increased import penetration, which accounted for 22 percent of the American market in 1984. The Administration's efforts to buy the industry some breathing space with voluntary quotas on imports has not yet produced results. So far, only one-third of the 76 steel-producing nations have agreed to limit their exports to the U.S. Moreover, worldwide steel capacity continues to exceed demand, and this imbalance has led to intense competition among nations for market shares and sharp price declines for steel products. Profitability has suffered, and in steel producing nations, unemployment, plant closings and painful restructuring are common.

Steel consumption in the U.S. depends primarily on demand for durable goods (both capital and consumer), such as construction machinery, autos, and appliances. The U.S. economy, however, is becoming increasingly less steel-intensive, and this diminishes the growth prospects for the industry. The energy crisis of the 1970s was one factor behind the long term decline in steel demand (the average American-made car today contains some 600 fewer pounds of steel than it did in 1976), as plastics and other products are substituted for steel. Another reason for the decline in steel demand is the steady shift away from goods produced by heavy industry towards electronics, services and information processing.

Individual companies will continue to compete fiercely for additional volume next year, especially in plate, large structural, and tubular product lines, where slack capacity is greatest. Improved efficiency and productivity are being realized through mergers, joint ventures, and the continued elimination of older facilities. The Inland Steel Company plans to pare expenses 20 percent by 1988 by reducing its excess productive capacity. Others, including the U.S. Steel Corporation, are considering joint ventures with foreign steel producers similar to the merger of the National Steel Corporation and Tokyo's Nippon Kokan. There is also an ongoing process of further cost-cutting, including employment reductions and the installation of more efficient high-tech equipment.

The steel industry's restructuring has extended to minimills. A rush of new entrants into this sector has resulted in overcapacity here as well, along with a sharp increase in competition. As the less efficient minimills are phased out, the stronger companies will continue to move into more profitable product lines such as special quality bar steel. Specialty steel producers (stainless, tools, and superalloys), which account for only 2 percent of the industry's volume, are also prospering because they do not face the large capital costs associated with blast furnaces and coke ovens.

As a consequence of the resurgence in economic growth forecast for next year, production should rise by 7.5 percent. However, because industry wages are over 50 percent higher than the national average, employment is expected to remain flat as producers attempt to contain costs.

Nonelectrical Machinery

The nonelectrical machinery industry has not escaped problems of weak demand and foreign competition that have plagued a large number of the nation's industries. Although the import penetration ratio for the industry as a whole stands at only 14 percent, this overall average conceals major differences between categories within this sector. At one extreme, there is virtually no foreign competition in the market for some sectors such as oil field machinery (import penetration ratio of 1 percent), internal combustion engines (5 percent), and pumps (7 percent). At the other, some industry sectors, including farm machinery, machine tools, and textile machinery, face import penetration ratios of 17 percent, 31 percent, and 46 percent, respectively.

In an effort to meet the challenge from foreign suppliers, the industry has stepped up purchases of replacement equipment to modernize existing facilities. Other efforts to improve the industry's international competitiveness include offshore purchases, joint ventures, licensing arrangements, and increased spending on research and development. For example, Warner & Swasey has an agreement with Murata of Japan to build lathes and other turning machines to their specifications. Nine of the 12 largest machine tool builders have either recently merged or become part of a conglomerate. Attempts to improve productivity, efficiency and international competitiveness have resulted in a considerable increase in spending on R&D. Cincinnati Milacron Incorporated is expanding its R&D budget by 20 percent next year while Cross & Trecker Corporation will increase theirs' by over 50 percent.

Demand from the auto and defense industries for all types of machinery is expected to remain strong in 1986. In addition, the continued trend towards automation, particularly in the metalworking industry, will increase the demand for machine tools linked by computer control. Similarly, the demand for robots is expected to grow. GMFanuc Robotics Corporation, which enjoyed a fourfold sales increase in 1984, expects demand for robots to increase by over 30 percent this year. For the nation as a whole, industrial robot production is expected to grow by about 16 percent in 1986. Technology will remain a key factor as the industry continues to search for even more efficient applications of the computer to machines and industrial processes.

Although companies that specialize in the production of machines for the oil, construction, and farming sectors faced relatively low import penetration ratios in 1984, foreign competition in their areas is intensifying. Producers in Japan, Europe, and Brazil are expanding their product ranges and matching U.S. technology in a continued effort to enter the lucrative U.S. market. The impact has already been felt in the construction and farm equipment industries, where imports accounted for over 50 percent of the market's growth during the recovery.

This year, U.S. tractor retailers managed only a 0.4 percent increase in their unit sales and 44 percent of all tractors sold were smaller models which did not produce much profit. Despite the heavy price discounting, production of farm equipment in 1986 is expected to decline by 2 percent, following an estimated 17 percent drop in 1985. This dismal performance is directly related to the depressed state of the farm economy (see *American Agriculture at the Crossroads*, ECONOMIC OUTLOOK, October 1985). In response to growing import pressures, some farm equipment companies have made substantial cost reductions in all of their production and management operations, while others have either closed down plants temporarily or left the business altogether. International Harvestor Company has sold its troubled farm equipment unit to Tenneco. Deere & Company has closed down its combine-harvestor plant in Illinois, and Massey-Ferguson and Allis-Chalmers are mothballing plants for part of next winter.

For the nonelectrical machinery industry as a whole, production is forecast to rise by only 1.1 percent in 1986, following a 3.4 percent increase in 1985. Industry employment is expected to fall by 0.9 percent in 1985 and decline by 1.6 percent in 1986.

Computers

The continued strength of the nation's service industries is reflected in the fact that production of office and miscellaneous equipment will continue to outpace output in the nonelectrical equipment industry as a whole. In fact, output growth in this sector has increased by almost 13 percent since the beginning of the recovery, compared to an 8.6 percent rise for the nonelectrical equipment industry as a whole.

Although its prospects remain good, production of office equipment should rise by only about 5 percent this year, and by half this amount in 1986. This compares to a 21 percent increase in 1984, when the famous high-tech Silicon Valley area was a strong source of new jobs and new companies. However this year, signs of a slowdown have become increasingly evident. Electronics companies are now facing saturated markets and mushrooming foreign competition. The share of imports in total U.S. consumption of computers stood at 19 percent in 1984, and the rate of growth in U.S. exports of computers, while expected to post a 13 percent rise this year compared to a projected decline for overall U.S. exports, has suffered a significant slide from the 28 percent growth rate achieved in 1984. As a consequence, employment growth in the industry has declined. Apple Computer laid off a fifth of its work force in a recent reorganization; Hewlett

Packard, facing unusually weak orders, mothballed most of its facilities for one to three days a month this summer.

Although U.S. computer equipment companies have always operated globally, it is only recently that they have established overseas assembly operations, not only to serve foreign markets but also to produce goods for the U.S. market. Corona Data Systems, a company that makes desktop computers, has cut prices by 42 percent and moved its production facilities to South Korea and Japan. Sluggish capital spending, severe domestic and foreign competition, price discounting, and contracted product cycles have stifled the ambitions of many firms. Large dealer inventories now weigh heavily on prospects for 1986 sales.

While the sales growth of personal computers is abating, demand for computer work stations – extra powerful personal computers for engineers and other professionals – have increased. Computer makers are introducing new models of business computers, developing new marketing strategies, and reducing prices in hopes of increasing computer sales. The minicomputer market, on the other hand, has been squeezed by cutbacks in corporate computer buying and the spread of desktop office computers. Minicomputer makers are moving more into direct sales, traditionally the province of mainframe makers. While growth in microcomputers is also slowing, sales of higher-priced desktop models to businesses are stronger than sales of less expensive computers to consumers. The mainframe market, the largest industry segment, has been discovering third party sales routes. For instance, the Sperry Corporation indicates that it will soon stop manufacturing computers and stitch together a product line with other companies' components.

Electrical Machinery

Although production of electrical machinery has risen by 8.7 percent since the end of the recession, the industry's recovery seems to have come to an end. The near term outlook calls for actual declines in production and employment this year and next. Production is expected to fall by 3.1 percent in 1986 following an estimated decline of 2.8 percent this year. Consequently, industry employment is expected to decline to 2.1 million workers next year from 2.2 million in 1984.

Depressed sales in the semiconductor business have dragged down the electronic and electrical equipment industry. Electronic components, which rose at rates above the industry average during the recovery, is expected to experience larger than average declines in production this year and next. U.S. semiconductor shipments have slipped 28.7 percent from a year ago because of strong competition from lower priced Japanese products. Imports accounted for 39 percent of the U.S. market for semiconductors in 1984. Exports of Japanese semiconductors to the U.S. were almost $2 billion last year, while U.S. exports of semiconductors to Japan amounted to only $251 million. In an effort to solidify their presence in the U.S. market and guard against the possibility of protectionist polices, Japanese producers are setting up plants in this country, providing manufacturing services to U.S. companies and in some cases, taking an equity position in domestic firms. NEC Corporation, a Japanese electronics firm, is building a $25 million factory in Oregon for the production of fiber optics equipment. Korea's Gold Star Semiconductor Limited has ties with LSI Logic that give it access to LSI's design technology. And LSI Logic has also announced plans for a $100 million joint venture with the Kawaski Steel Corporation.

Demand in the electrical machinery industry is estimated to have declined 2.8 percent this year. Nineteen eighty-five has been characterized by spot shortages, longer lead times, and firm pricing patterns. Next year will bring further declines in production for the industry as output of household appliances, communication equipment, and T.V. and radios deteriorates. The T.V. and radio category, faced with an import penetration ratio of 59 percent, is expected to see production fall by 17 percent this year and 28 percent in 1986. Demand will shift somewhat in composition, with the computer, consumer and industrial sectors accounting for declining market shares, while demand from the defense sector contributes more to sustaining the industry.

Transportation Equipment

Following the energy crisis of 1979, the combination of a major shift in consumer demand, sluggish economic conditions, and intensified international competition plunged the transportation equipment sector into the worst crisis in its history. Three problems in particular – high U.S. labor costs, uncompetitive product quality, and shortcomings in management practices – placed domestic producers at a serious disadvantage in relation to their Japanese counterparts. In responding to these critical challenges, the industry has made some dramatic changes. It has drastically restructured its product lines, modernized factories, streamlined operations and, in doing so, has increased productivity, reduced costs, and improved the quality of its products.

The transportation equipment sector tends to be one of the most cyclical sectors in the U.S. economy, and as a result, it has benefited significantly from the economic upturn. Production is estimated to increase by 8.4 percent this year and 4.3 percent in 1986. Consequently, industry employment is expected to rise 3.3 percent in 1986. The motor vehicles and parts sector is likely to post below average growth rates, while the production of aircraft and railroad equipment will enjoy substantial increases. The aircraft industry is projected to increase production by almost 12 percent this year and 9.5 percent in 1986 as airlines expand capacity in efforts to compete for traffic volume.

Long-term industry growth will be largely determined by their degree of success in implementing new technologies designed to speed up production and cut costs. A majority of the industries comprising the transportation sector continue to face intense foreign competition. Car makers, in an effort to remain competitive with the Japanese, are adding new high-tech companies to help link design and engineering with production, and expanding financial services to facilitate marketing and sales of domestic cars. Domestic car sales are expected to remain close to the 8 million unit level this year and next. However, sales of imported cars are anticipated to be over 3 million units in 1985 and 1986, compared to 2.5 million units in 1984. Although U.S. car sales reached feverish levels in late summer of this year because of the subsidized interest rates on car loans, this sales promotion was expensive and hurt the earnings of the big three automakers as sales volume did not completely offset costs. Domestic automobile production should increase by 2 percent in 1986 compared to an estimated 9.8 percent this year. While U.S. imports of motor vehicles are estimated to have risen by almost 18 percent this year, exports rose by 23 percent.

The U.S. auto industry is undertaking new product and plant modernization programs of unprecedented scope to regain international competitiveness. In the tried and true spirit of "if you can't beat 'em, join 'em," they are also engaging in a host of mergers and joint ventures with foreign affiliates. As in the case of the nonelectrical machinery sector, foreign automakers are setting up production facilities in the U.S. Honda Motor Company, Mazda Motor Corporation, and Nissan Motor Corporation are among the Japanese automakers that have established production plants in the United States.

Similarly, airlines are making acquisitions in the areas of high-tech and car rental agencies. The railroad and trucking industries are utilizing each other's comparative advantages to lower costs through intermodal transportation. With emphasis currently placed on volume rather than profits, price slashing, incentives and discounts will abound; hence, these types of cost-cutting efforts will be crucial if steady growth is to be attained.

The continuing economic recovery and expected stability in gasoline prices are hopeful signs for the truck sector. The light truck market should continue to grow steadily for the next few years. Compact vans and pickups have retained their popularity because of improved fuel efficiency and their load carrying ability. Production in this sector is expected to rise by 9 percent in 1986, significantly above the average for the industry as a whole.

Instruments

The instruments industry, consisting principally of scientific and industrial measurement equipment and consumer products such as cameras, continues to be one of the more profitable manufacturing sectors. Instruments are of major importance in the manufacturing process as they reduce inefficiency and increase both the quantity and quality of production. Thus, as expenditures for plant and equipment increase, so does the demand for instruments. Another factor influencing the industry is expenditures on research and development, a large user of instrumentation. The trend toward integrating computer technology with instrumentation should continue next year, along with increases in private and government R&D spending. The expected continuation of the downtrend in the value of the U.S. dollar and its eventual impact on U.S. exports will be a plus for this industry for which foreign markets are also important sources of revenues. Industry exports are estimated to have risen an astonishing 20 percent this year in the face of falling overall U.S. exports. At the same time, the rate of increase in U.S. imports of instruments has slowed to 16 percent, half the increase experienced in 1984. Production in the industry is expected to increase by 2.3 percent next year and employment should rise by 1.4 percent.

Compared to the average increase for durable manufacturing as a whole, the improvements in production and employment anticipated for this year are quite respectable, even though the industry continues to face a host of negative factors. The still high value of the dollar relative to the currencies of our major trading partners, the sluggish economic recovery in other industrialized nations, the severe liquidity problems that have reduced capital expenditures and imports in developing countries, and the increasing competitiveness of Japanese and European manufacturers will all continue to limit market opportunities for U.S. instrument firms next year. Further, import penetration of the U.S. market stands at 14 percent, with Japan accounting for nearly one third of all imported instruments.

Food and Products

Changing consumer tastes, demographic shifts, and slow population growth signal significant shifts in the structure of the food and products industry over the next few years. Increasingly, mergers and acquisitions are changing the character of the American food industry. The cigarette maker, Philip Morris, recently agreed to buy General Foods for $5.8 billion; R.J. Reynolds paid $4.9 billion for Nabisco Brands; and Nestle acquired Carnation Company for $3 billion. Reflecting improving economic conditions and efficiencies accruing from consolidation and concentration, food industry profits will continue to increase in 1986, as will industrial production and employment, which are expected to rise by 4.3 percent and 0.5 percent, respectively.

Many major food processors claim that the strength of the dollar limited profits on export sales. Earnings on highly processed and specialty food generally rose, while meat processors' earnings were squeezed by low consumer demand and low commodity prices. In today's deflationary environment, food processors no longer find it easy to maintain margins by raising prices.

Reflecting the continued decline in the value of the U.S. dollar, the trend in industry exports and imports is expected to reverse. Real exports of foods, feeds and beverages are expected to rise by 10.5 percent in 1986, following a 15 percent decline in 1985. Real imports, which are anticipated to post a 7.4 percent rise in 1985, should fall by almost 10 percent in 1986. Traditionally the U.S. has been a net exporter in this category, however, the surplus shrank from $4.8 billion in 1983 to $2.1 billion in 1984. During 1985 the surplus in this category of merchandise trade is expected to return to previous levels, reaching $4.3 billion.

Tobacco Products

Developments in the cigarette industry during 1985 were dismal. Unit sales dropped for the third year in a row, cigarette makers were forced to discount retail prices, the anti-smoking campaign continued unabated, and Congress required even tougher health warnings on cigarette packs. As a result, industry production should show a 4.3 percent decline this year. Nevertheless, profits increased substantially. Aided by higher cigarette prices and lower unit costs, Philip Morris, the largest cigarette producer, reported a 23 percent gain in profits in the third quarter.

Industry analysts expect companies to continue to benefit from improving productivity and lower raw material costs in 1986. Consequently, next year should see a small increase in production. However, increasing productivity in the industry means that higher levels of production can be achieved with fewer workers, and this is reflected in an expected 5.6 percent decline in 1986 industry employment. Also affecting employment is the fact that average earnings in the tobacco industry are significantly above the national average.

Following the sharp drop in cigarette demand after the 1983 tax and price increases, cigarette makers began development of new product and pricing strategies. Last year, major developments occurred in the lower priced cigarette segment as the demand for generic cigarettes increased. Generic cigarettes are offered at substantially reduced prices in plain packaging, with no advertising or promotion. In another marketing strategy, R.J. Reynolds began testing a 25-count pack of the largest selling U.S. cigarette brand, priced 25 cents above branded 20-count packs. In addition to price differentials, product innovations introduced by cigarette makers included longer cigarettes and products positioned to appeal to special market segments such as women and low-tar smokers.

Cigarettes are the major export of the U.S. tobacco industry. In an effort to offset weakening U.S. demand, several manufacturers have been exploring means of increasing sales overseas. The quantity and value of U.S. cigarette exports rose annually through 1981 and then began to decline because of the growing strength of the U.S. dollar and import restrictions abroad. However, a turnaround was evident this year as cigarette and cigar exports are estimated to have increased by 6.9 percent, following virtually no improvement in 1984. On the import side, while foreign suppliers, particularly of cigars and snuff, are making gains in the U.S. market, the industry has an import penetration ratio of only 0.5 percent and imports of tobacco are estimated to have declined by 6.3 percent this year.

Textile and Apparel Products

The economic fortunes of the U.S. textile industry are closely tied to those of apparel manufacturers. U.S. textile firms sell 45 percent of their output to apparel makers, and in some cases textile firms also have apparel operations. Since 1980, these industries have reduced employment by more than 110,000 jobs and have closed over 250 plants. Industry leader Burlington Industries Incorporated, whose activities span both the textile and apparel industries, has closed three apparel/fabric mills in the past 18 months.

Both industries have undergone massive restructuring in order to increase both foreign and domestic competitiveness. A number of domestic apparel firms are trying to enhance their competitive positions and reduce costs by making use of "sourcing"–engaging suppliers outside the firm to furnish some or all components at various stages of the manufacturing process. To further increase competitiveness, firms in the industry have increased automation and imposed better cost controls. Extensive use of computers has speeded up the manufacturing process and increased efficiency in both industries. For instance, Hartmarx Corporation, a domestic suit manufacturer, uses computers to find the most efficient way to mark patterns on cloth; also, instead of sewing linings inside suits, these are now chemically fused.

However, technological improvements can only go so far in the apparel business which remains highly labor-intensive. The industry can, however, compete by going after particular segments of the market. For instance, domestic manufacturers can compete well in the high-fashion apparel business which changes rapidly. By offering shorter lead times and better quality control than foreign suppliers, particularly those in the Far East, domestic firms can sharply improve their competitive edge. Many textile manufacturers are also placing increased emphasis on fabrics for specialized uses. For example, Avondale Mills of Alabama is hoping to reduce the amount of commodity-type textile (such as denim), that it sells to apparel makers from 75 percent of its business to 25 percent. Collins & Aikman Corporation attributes its dramatic increase in profits during 1985 to its strategy of diversifying away from apparel, which now accounts for only 13 percent of its sales. J.P. Stevens & Company, the second largest textile company in the U.S., has announced plans to divest its apparel fabrics divisions and devote more of its resources to the company's home furnishings and industrial segments, where new applications in the use of textiles are creating substantial growth opportunities. The industry has also launched an $11 million "Buy American" advertising campaign for this year and next.

As a result of these efforts, textile production, which is estimated to show an almost 2 percent decline this year, should rise by 6.1 percent in 1986. This turnaround will contribute to an employment increase of 10,000 workers. Production in the apparel sector, which is estimated to have declined by almost 2 percent this year, should show a slight improvement in 1986. Employment in the apparel sector, however, is expected to continue to decline. Average hourly earnings in both industries are well below the national average.

Despite the progress already made, however, industry analysts claim that the industry's restructuring process still requires greater effort in the following areas: diversification of companies to achieve growth in areas where foreign competitors are weak; development of more specialized product lines and market segments; increased use of advanced technology; consolidation through mergers; and the development of stronger export markets.

Paper and Products

Encouraged by strong demand, high operating rates, and greatly improved earnings, paper producers in the U.S. are expected to increase their capital spending plans in 1986. Responding to tight markets, a number of companies announced plans for purchasing new machines as well as several new mills. Union Camp Corporation has spent $500 million on a mill in South Carolina that will increase its productive capacity by 30 percent next year. Aided by enhanced productivity, the benefits of cost-cutting measures initiated during the recession, and the inherent economies accruing from high operating rates, industry profits should increase further in 1986. Although growth in consumer demand for paper products will not contribute much to industry performance, brisk expansion in business demands will result in increases in production and employment during 1986 of 3.2 percent and 1.6 percent, respectively.

However, the increase in output will not be uniform among the industry's subsectors. Some segments of the industry, such as uncoated free sheet, linerboard, and market pulp, have experienced price weakness and competition from imports which are expected to continue in 1986. On the other hand, makers of coated paper and the uncoated free sheet used for computer printouts and copiers will continue to enjoy steady growth. Companies are concentrating their efforts in areas such as sanitary papers where prices are stabler and demand outruns supplies.

Problems plaguing the industry's future growth include inroads made by plastics into the domestic paper market, as witnessed by the growth of plastics in the grocery sack market. Other market losses may result from the increasing use of telecommunication devices that transmit information electronically. Nevertheless, the paper and board industry is in an excellent position to serve its huge domestic market and to compete aggressively in foreign markets.

Printing and Publishing

The U.S. printing and publishing industry is the world's largest of its kind, employing more than 1.4 million people, and accounting for 18 percent of U.S. nondurable manufacturing employment. It also represents the largest conglomeration of small businesses in the manufacturing sector. Growth of printing and publishing depends on a number of factors, but particularly on business confidence—evidenced through advertising expenditures—and gains in disposable personal income. Other factors include population growth, higher educational attainment, and increased personal consumption expenditures. In view of the favorable outlook for these demographic and economic factors, the industry is expected to grow at an average rate of about 5.4 percent in 1986 following a 4.9 percent rise in output in 1985. Sales of printed products should rise in 1986, with the increase being led by advertising in newspapers and magazines.

Advances in technology have affected virtually every phase of the industry's operations. Productivity increases are especially noticeable in the typesetting and pre-press operations of many newspaper and commercial printing firms. Changes in printing presses and increased automation in binding, handling, and mailing have increased production with minimal additions to payrolls. The challenges to the industry are many. The various electronic media are making increased inroads on the consumers' attention, yet the print media have many advantages over the electronic media, including portability, low cost, accessibility, and storage.

While international sales are not a principal concern to many printers and publishers, the U.S. is a net exporter of printed matter and the second largest exporter, behind West Germany. Shipments of U.S. printed matter destined primarily for Canada, England, Australia, and Japan totaled $1.3 billion in 1985, and should increase further next year.

Chemicals and Products

The chemical industry is expected to post its strongest increase in three years during 1986 as production rises by

6.4 percent, significantly above the average for nondurable manufacturing as a whole. The strength in the housing and automobile sectors, the industry's major markets, will buoy chemicals production, particularly in synthetic materials which are expected to enjoy a 10.3 percent increase in production next year.

Strength in the industry's key sectors (basic chemicals, synthetic materials, and drugs and medicines), will offset weakness in other categories, particularly agricultural chemicals. Sales of phenolics, used in manufacturing, plywood and other construction materials, is expected to grow by 5 percent next year. Shipments of epoxy resins, whose main markets are the automobile and metal can industries, were up 20 percent in 1985 and should increase by an additional 10 percent next year. Demand for synthetic fibers, however, continues to be weak due to shifts in consumer preferences away from nylons. Consumers will account for some of the strength expected next year as output of both pharmaceuticals and soaps and toiletries are expected to improve. Next year will continue to be bleak for U.S. producers of pesticides, fertilizers and other agricultural chemicals because of the depressed state of the farm economy. Production of this category of chemicals is expected to decline by 6.3 percent next year following an estimated 4.6 percent decline in 1985.

The recent weakening of the dollar against the major currencies should contribute to the industry's turnaround. The industry has suffered from foreign competition in domestic markets, where imports account for 21 percent of the market for basic chemicals, and international markets, where Kuwait, Saudi Arabia and Canada have all expanded their organic chemical capacity. Further, import penetration in autos, household appliances, consumer electronics, computers and apparel, has reduced these industries' demand for chemicals. To improve their ability to compete, the chemicals industry plans to increase capital spending in 1986 by 10.7 percent in order to reduce operating costs and increase productivity.

Petroleum Products

The petroleum products industry is also expected to enjoy a turnaround next year. After an estimated decline of nearly one percent in 1985, production should increase by almost 3 percent in 1986. Although this represents an improvement for the industry, its performance still remains significantly below the 4.9 percent increase in production forecast for nondurable manufacturing as a whole.

Companies continue to restructure and streamline operations to adjust to long-term changes in the marketplace. Energy conservation is probably the single most important factor affecting the financial fortunes of oil companies today. Moreover, imports are hurting domestic refiners who are struggling to get their production runs up to profitable levels. Mergers and joint ventures will continue to occur within the industry as firms realize it is cheaper to increase crude-oil reserves via acquisitions than to engage in costly exploration and drilling. The recent proposed merger of U.S. Steel Corporation (which already owns Marathon Oil), and Texas Oil & Gas Corporation is the latest consolidation in the natural gas business.

Petroleum consumption in 1985 is estimated to rise by nearly 5 percent, the first increase in six years, with the largest gains in demand occurring in the distillate fuel oil and jet fuel categories. Consumption of natural gas in 1986 by the industrial sector and electric utilities is expected to increased more rapidly than consumption in the residential and other commercial sectors. Demand for natural gas is expected to rise by 3 percent next year but the supply surplus will continue to hang over the market. The electric utility industry will also see modest growth next year. In 1985, the industry is estimated to have sold 5 percent more electricity than it did last year.

Rubber Products

Propelled by the strong demand generated by such markets as housing, appliances, and autos, the rubber industry should see relatively strong growth next year. Production is forecast to increase by 6.1 percent in 1986 as plastics outperform other segments of the industry. Overall employment in the industry should increase by 1.3 percent next year. Both rubber and plastic products are sensitive to the cost and availability of petrochemical raw materials; hence, as a result of stable petroleum and natural gas costs, plastic and rubber prices in the last few years have remained relatively unchanged. There continues to be an ongoing, long-term shift away from rubber towards plastic products because they are less expensive to process. Consequently, production of plastic products is expected to provide the bulk of the industry's strength, rising by 9.9 percent next year, while the output of tires increases by only 4 percent and the output of other rubber products falls by almost 9 percent.

Over 70 percent of the synthetic rubber produced is consumed in the manufacture of tires and other rubber products for motor vehicles. The worldwide shift to radial car tires in the early 1970s gave a new lease to the life of the natural rubber industry since radial tires require more natural rubber in their blend than do cross-ply tires. But, since radial tires last longer, the demand for replacement tires will continue to decline. In addition, radial tire imports from Korea and other Asian countries continue to soar, accounting for over 20 percent of the market. The trucking industry has increased its demand for longer lasting tires with less rolling resistance in order to cut operating costs. Demographic changes, consumer attitudes, and changes in tire and transportation technology will all shape the future of the tire industry.

Although earnings fell this year because of weak demand for replacement tires, next year should see an increase as the automobile industry raises its demand for tires, hoses, belts, and other auto parts. At Goodyear Tire & Rubber, the industry's largest company, profits fell 27 percent in 1985 because of lower demand for private-brand replacement tires, price-cutting by producers jockeying for market share, a strike at a Canadian tire plant, a glut of imported tires, and the strong dollar, which cut dollar earnings of foreign operations. Apart from cutbacks in bias tires, companies continue to reshape their businesses in order to improve productivity, reduce costs, and compete more effectively abroad. B.F. Goodrich & Company has begun concentrating on making replacement tires, while Firestone Tire & Rubber Company has closed its manufacturing plants and become a retailer, concentrating on marketing strategies for foreign markets. Manufacturers are also focusing on producing specialty tires, such as aircraft tires and agricultural equipment tire products, where imports as a share of the domestic market are negligible.

Leather and Products

Although the U.S. is one of the principal suppliers of leather to world markets, the proximity to raw materials has not helped the domestic fabrication industry in its struggles with foreign competition. Imports account for 47 percent of domestic consumption of leather goods. With the exception of leather tanning, all sectors of the industry are labor-intensive, and lower wage rates in many developing countries give foreign suppliers a substantial cost advantage. The developing countries' 1985 share of total U.S. imports of leather and leather products reached 73 percent.

The leather footwear industry, which labors under a 51 percent import penetration ratio, is composed primarily of privately held, family businesses. Despite such intensive import pressures, U.S. exports of leather footwear have enjoyed significant increases during the past two years even while total U.S. exports were falling. At the same time, the rate of growth in imports of this category of leather products has slowed substantially. The Footwear Industries of America, the industry's trade organization, has been lobbying heavily for import quotas which the Administration has rejected. Without drastic changes in the industry's competitiveness, import penetration ratios will increase and the industry's long-term prospects will remain dismal. The disparity in labor costs between many foreign suppliers and U.S. producers could be narrowed significantly with the application of new technology, especially robotics, but the large capital investment required is beyond the reach of many of the small and medium-sized producers.

Overall production is expected to decline by 7.5 percent next year following a 6.1 percent decline in 1984. Reflecting the industry's shrinkage, total employment should decline by 2 percent in 1986.

TRENDS IN COMMERCE
NOTES ON TABLE II
NOVEMBER, 1985

by

Martin Lefkowitz

Gross National Product (GNP)–The Department of Commerce's preliminary estimate of the nation's economic performance as measured by Gross National Product–the value of the output of goods and services–shows that the inflation-adjusted growth rate for the third quarter was 3.3 percent. This was an improvement from the second quarter when the economy grew at a revised 1.9 percent annual rate. Personal consumption expenditures, residential investment and government purchases accounted for most of the third quarter increase. Although inventory investment has declined, sales have increased and businesses should start to rebuild inventories in the fourth quarter to accommodate the higher sales levels. Net exports were at about the same level as the second quarter, while imports declined slightly.

The Services Sector–Employment in service sector establishments rose by 0.4 percent in October and is now 4 percent above its year-ago level. This compares with a 0.5 percent increase in employment in the goods producing sector over the last year.

In the last two months we have seen a reversal in the trend toward rising purchases of consumer services relative to consumer goods because of the recent increase in automobile sales. Consumer purchases of services now comprise 50.4 percent of personal consumption expenditures, compared to 50.1 percent in September 1984. Major domestic airlines reported that revenue passenger miles flown, that is, the number of passengers multiplied by the miles flown by each passenger, hit a record 30.9 billion, an increase of 11.9 percent from last year. The previous record was set in July when 30 billion revenue passenger miles were flown. For the first eight months of 1985, major U.S. carriers reported a 13 percent increase in revenue passenger miles flown from the same period in 1984.

Money Supply–The nation's money supply–as measured by M-1, currency in circulation plus demand deposits–increased by 0.9 percent from August to September, compared to a 1.7 percent increase from July to August. The money supply has been growing at a 13.8 percent seasonally adjusted annual rate in the latest three-month period.

Employment–The civilian unemployment rate remained unchanged at 7.1 percent in October for the second consecutive month. The stickiness in the unemployment rate over the past year should not be interpreted as a sign of economic weakness but is indicative of significant and rapid growth in the labor force. The percentage of the adult population at work in October reached a record high and employment gains continued. Civilian employment—as measured by the monthly survey of households—increased by 323,000 persons (seasonally adjusted), following an increase of 372,000 from August to September. The number of nonagricultural payroll jobs—as measured by the monthly survey of business establishments—increased by 414,000 in October, reflecting an across the board gain, including an increase in manufacturing jobs.

Prices—The Consumer Price Index for all urban consumers (CPI-U) increased a meager 0.2 percent in September for the fifth consecutive month. The slowdown in the rate of growth of consumer prices that has occurred in the last five months reflects lower prices for used cars and energy, while food prices, which had declined in the previous four months, increased in September. The government continues to be a major contributor to fueling inflation as the two components of the CPI that are dominated by government programs, medical care and educational expenditures, increased more than twice as fast as the total index over the last twelve months. During the first 9 months of the year, consumer prices rose at an annual rate of 3.2 percent.

Wholesale prices of finished goods rose 0.9 percent in October, following a 0.6 percent decrease in September, and were up 1.1 percent from their year-ago level. The October increase in finished goods prices was the largest rise in over a year. From October 1984 to October 1985, the finished goods index increased by 1.1 percent. This increase is about one-third the 3.2 percent increase in consumer prices during the last twelve months, reflecting the fact that the Producer Price Index measures only the goods sector of the economy while the Consumer Price Index measures both goods and services.

Crude prices increased 3.1 percent in October following 10 consecutive months of declines. Crude food and feedstuff prices increased 6.3 percent in October, but were 8.3 percent below their level a year ago, continuing to cause problems for American farmers. Prices of crude energy materials are 5.6 percent below their year-ago levels and nonfood materials, not including energy, are now 4.2 percent below their levels of last year.

Housing Starts—Privately owned housing units were started at a seasonally adjusted annual rate of 1,543,000 in September, 9 percent below the August level. Building permits, an indicator of future activity in the home building industry, increased one percent in September and were 18 percent above year-ago levels, indicating that housing starts should pick up over the next few months. However, recent trends in new home sales indicate that they have now declined 8 percent from their peak in July.

Industrial Production—Industrial production was down 0.1 percent in September, following a 0.6 percent gain in August. The decline in output was centered in the consumer goods and business equipment areas, while there were output increases in the defense and space equipment, and construction supplies sectors. Consumer goods output was down 0.3 percent as a result of declines in auto output and home goods, including appliances, while consumer nondurable goods production remained unchanged for the month.

The capacity utilization rate in manufacturing fell 0.3 percentage points in September to 80.0 percent. Motor vehicles and parts, electrical machinery, and nonelectrical machinery all showed the largest declines in utilization rates. Manufacturing capacity was 1.8 percentage points below the peak level attained in 1984, with most of the decline attributable to the durable goods sector. In the nondurable sector, the operating rate at 83.1 percent, was unchanged for the month. Manufacturing capacity rose 0.8 percent in the third quarter of 1985, a 2.4 percent increase from a year ago.

Productivity—Nonfarm business productivity increased at a 1.2 percent annual rate in the third quarter, similar to the second quarter gain. In the third quarter, output in the nonfarm business sector grew at a 3.2 percent annual rate as a result of an increase of 2.0 percent in the number of hours worked and a 1.2 percent increase in productivity. Manufacturing productivity in the third quarter grew at a 2.4 percent annual rate while output rose at a 2.3 percent annual rate, reducing the number of hours worked by 0.1 percent

Interest Rates—At 9.5 percent, the prime interest rate is 3.0 percentage points below the rate at this time last year. Three- and six-month Treasury bill rates in the last week of October were up 25 and 32 percentage points, respectively, from their levels at the end of September. The longer term Treasury securities were 24 percentage points lower the last week of October than the last week of September.

Business Failures and Formations—Dun and Bradstreet's Index of Business Failures indicates that business failures in mid-October declined slightly from their previous levels. Business failures in the first nine months of 1985 increased by 8.2 percent from their year-ago levels, and total business closings were up about 13.8 percent.

Dun and Bradstreet reported that there were 59,655 new business corporations formed in May, an increase of ten percent from the previous year. In the first five months of 1985, 281,533 new corporations were formed, an increase of 4.3 percent from last year. Twenty states had increases of 10 percent or more, and all of the nine census regions reported an increase in new business cor-

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Aug/85	239.0	238.1	236.9	0.4	0.9
Gross National Product ($B)	III/85	3,916.1	3,853.1	3,694.6	1.6	6.0
Gross National Product (72$B)	III/85	1,684.8	1,671.3	1,645.2	0.8	2.4
Money Supply (M1) ($B)	Sep/85	611.6	605.9	551.5	0.9	10.9
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Sep/85	2,566.6	2,536.1	2,383.7	1.2	7.7
Personal Consumption Expenditures (72$B)	Aug/85	1,114.8	1,103.1	1,059.5	1.1	5.2
Disposable Personal Income ($B)	Sep/85	2,717.3	2,713.0	2,624.9	0.2	3.5
Disposable Personal Income (72$)	Aug/85	1,192.6	1,191.3	1,174.7	0.1	1.5
Personal Savings Rate (%)	Oct/85	1.9	2.9	6.1	-1.0[b]	-4.2[b]
Civilian Employment (millions)	Oct/85	107.9	107.5	105.6	0.4	2.2
Civilian Unemployment Rate (%)	Oct/85	7.1	7.1	7.3	0.0[b]	-0.3[b]
Average Hourly Earnings	Oct/85	$8.64	$8.64	$8.38	0.0	3.1
Consumer Price Index (All Urban, 67 = 100) [a]	Sep/85	324.5	323.5	314.5	0.2	3.2
Purchasing Power of the Dollar (67 = $1.00) [a]	Sep/85	0.308	0.309	0.318	-0.324	-3.145
Prime Interest Rate (%) November 2, 1985		9.5	9.5	12.5	0.0[b]	3.0[b]
Retail Sales ($)	Oct/85	115.5	119.4	109.0	-3.3	6.0
SERVICES SECTOR						
Employment in Services (Millions)	Oct/85	73.1	73.0	70.4	0.3	4.0
Consumer Purchases of Service ($B)	Sep/85	1,292.9	1,285.1	1,193.8	0.6	8.3
Consumer Purchases of Service (72$B)	Aug/85	511.9	511.1	493.6	0.2	3.7
Revenue Passenger Mileage Flown Major Airlines (Billions) [a]	Aug/85	30.9	30.0	27.6	5.3	14.7
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B) [a]						
Before Tax [a]	II/85	221.0	222.3	246.0	-0.6	-10.2
After Tax [a]	II/85	137.4	137.0	150.2	0.3	-8.5
Industrial Production (67 = 100)	Sep/85	124.7	124.8	123.3	-0.1	1.1
Capacity Utilization Rate (Mfg.) (%)	Sep/85	80.0	80.3	82.0	-0.3[b]	-2.0[b]
New Housing Starts (thou. units)	Sep/85	1,583.0	1,746.0	1,669.0	-9.3	-5.2
Net Business Formation (67 = 100) [a]	Aug/85	119.0	118.0	119.1	0.8	-0.1
New Business Incorporations (Thousands)	May/85	56.3	55.9	51.2	0.7	10.0
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	III/85	165.2	164.1	159.5	0.7	3.6
Unit Nonlabor Costs (nonfarm) (77 = 100)	III/85	163.7	161.3	158.0	1.2	3.6
Producer Price Indices (67 = 100)						
Crude Materials	Oct/85	298.0	292.4	319.6	3.1	-6.8
Intermediate Goods	Oct/85	317.8	317.9	320.1	0.1	-0.7
Finished Goods	Oct/85	294.8	290.2	291.5	0.9	1.1
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100)	Sep/85	594.7	590.4	521.0	0.7	14.1
Federal Government Debt Outstanding ($B) [a]	Jun/85	1,779.0	1,758.3	1,517.2	1.2	17.3
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	III/85	347.6	347.7	368.6	0.0	-5.7
Imports of Goods & Services ($B)	III/85	436.7	441.6	459.3	-1.1	-4.9
Balance on Goods & Services ($B)	III/85	89.2	94.0	90.6	-5.1	-1.5
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	Sep/85	170.3	170.2	165.7	0.1	2.8

NOTES: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted

[b] Percentage point difference

porations formed in May of 1985 compared to 1984. The East North Central region reported the largest gain in incorporations in May, with an 18.7 percent increase. The South Atlantic states reporting the largest increases in new corporations during the first five months of 1985 were South Carolina, Louisiana and Maryland.

Federal Spending—The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, increased 14.1 percent in September from its year-ago level, after adjusting for the fact that two Social Security payments were made in August 1984 because of the timing of the Labor Day weekend. This is more than four times the 3.2 percent annual rate of increase in consumer prices over the last twelve months. In fiscal year 1985, federal expenditures increased by 11.3 percent, nearly four times as fast as prices, indicating a real increase in federal spending of about eight percent from the year-ago level. Federal receipts, during the same period, have risen by 10.1 percent as a result of double-digit increases in personal income taxes and social insurance taxes. The data on tax receipts indicates that federal tax revenues continue to increase at a faster rate than increases in income. The faster growth of taxes and federal outlays than prices indicates that we must concentrate on expenditure reduction in order to bring the federal deficit under control.

Personal Savings—In September, for the first time since 1959, the personal savings rate hit an all time low of 1.9 percent of after-tax income. The decline in savings appears to be a result of increased consumer expenditures that occurred in the summer months. Personal consumption spending rose 1.2 percent in September, following a one percent increase in August.

Retail Sales—Retail sales declined 3.3 percent in October following increases of 2.1 percent in September, and a 2.2 percent increase in August. The October decline was expected as consumers paused following a two month spending binge. The September increase was mainly due to a jump in auto sales as dealers offered larger than usual end of the year discounts combined with favorable financial terms. The most encouraging factor was that October retail sales were ahead 6.0 percent from last year's level and for the last three months, retail sales are up 2.6 percent, a better than 10 percent annual rate. This indicates a continued upward trend in retail sales.

Trade Deficit—The trade deficit declined slightly in the third quarter following very large increases in the first two quarters of 1985. On a goods and services basis, the trade deficit declined to $89 billion in the third quarter, following an increase to $94 billion in the second quarter. The decline in the trade deficit was due to a decrease in imports while exports remained unchanged. On a monthly basis, the merchandise trade deficit jumped to a new record, over $15.5 billion from just under $10 billion in August. The September increase in the merchandise trade deficit is attributable to a 24 percent increase in imports of manufactured goods. In September, nearly one-half of the nonpetroleum related trade deficit was with Japan.

What's Ahead—The composite index of leading indicators, designed to predict future movements in aggregate economic activity, increased 0.1 percent in September, with 5 of the 11 available indicators up, 5 were down and one was unchanged. This follows a revised 0.9 percent increase for August that was previously reported as a 0.7 percent gain. September represents the fifth consecutive month in which the leading indicators have increased.

MAJOR EXPORT COUNTRIES TO THE U.S.
($ billions)

	1983	1984	% Change 1984/83
Canada	32.1	66.5	+28
Japan	41.1	57.1	+39
Mexico	16.8	18.0	+ 7
West Germany	12.7	16.9	+34
United Kingdom	12.5	14.5	+16
Taiwan	11.2	14.8	+32
South Korea	7.1	9.4	+31
Hong Kong	6.4	8.3	+29
France	6.0	8.1	+35
Italy	5.5	7.9	+45
Indonesia	5.3	5.5	+ 3
Brazil	4.9	7.6	+54
Venezuela	4.9	6.5	+32
Nigeria	3.7	2.5	−33
Saudi Arabia	3.6	3.7	+ 3

Source: U.S. Department of Commerce

MAJOR IMPORT COUNTRIES FROM THE U.S.
($ billions)

	1983	1984	% Change 1984/83
Canada	38.2	46.5	+22
Japan	21.9	23.6	+ 8
United Kingdom	10.6	12.2	+15
Mexico	9.0	11.9	+32
West Germany	8.7	9.1	+ 4
Saudi Arabia	7.9	5.6	−30
Netherlands	7.8	7.6	− 3
France	5.9	6.0	+ 1
South Korea	5.9	5.9	+ 1
Belgium/Luxembourg	5.0	5.5	+ 9
Taiwan	4.6	5.0	+ 7
Australia	3.9	4.7	+21
Italy	3.9	4.4	+12
Venezuela	2.8	3.4	+20

Source: U.S. Department of Commerce

EXPORT RELATED JOBS IN MANUFACTURING DECLINE IN 1983

There were 4.5 million jobs associated with the export of manufactured goods in the U.S. in 1983, according to the latest data by the Department of Commerce. These export related jobs constituted 4.3 percent of the nation's total work force in 1983, compared to 4.7 percent in 1981. Within the manufacturing sector, exports accounted for 11 percent of the total manufacturing employment in 1983, including 1.1 million jobs in manufacturing plants producing the finished goods for direct export, and an additional 0.9 million jobs in manufacturing plants and administrative offices furnishing material inputs and services to the exporting plants. In addition, there were 2.5 million employees in nonmanufacturing industries that supply materials and services supporting manufactured exports. This included employment in trade, business, transportation, communication and utilities, agriculture, mining, and other industries.

DEPARTMENT OF COMMERCE REPORTS INCREASE IN PERSONAL INCOME

The Department of Commerce's Bureau of Economic Analysis recently reported that personal income for the nation as a whole rose 1.0 percent in the second quarter. Of the forty-two states that showed an increase in personal income, the largest percentage increase in nonfarm income were in: Wyoming, 3.1 percent; Indiana, 2.0 percent; Kansas, 1.8 percent; Arizona, 1.7 percent; and Florida, 1.6 percent. Most of these states showed large increases in wage and salary disbursements (payrolls) in both durables and nondurables manufacturing and private service-type industries. Declines in nonfarm personal income occurred in Montana, Delaware and Alaska. Those states showing a decline in personal income as a result of depressed farm activity include North Dakota, Arkansas, Mississippi, Louisiana, and Idaho

The following is a summary of the changes in nonfarm personal income in the second quarter for each of the eight BEA regions:

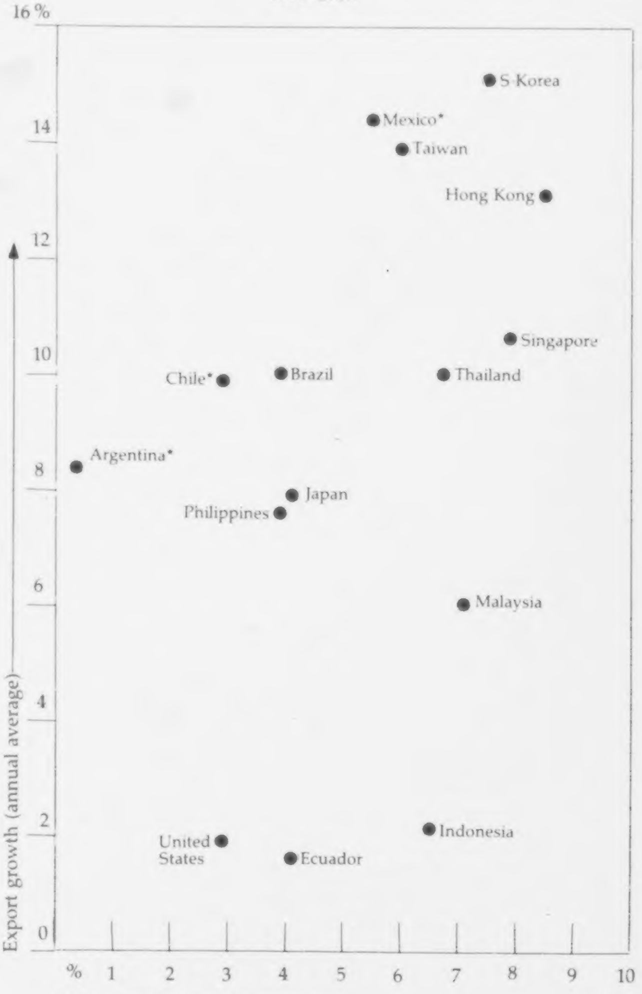
Region	Percent Increase in Nonfarm Personal Income
New England	1.1%
Mideast	0.9
Great Lakes	1.2
Plains	0.9
Southeast	1.1
Southwest	1.3
Rocky Mountain	1.2
Far West	1.1

EXPORT GROWTH AND DEVELOPMENT

The discrepancy between the economic performance of the East Asian and Latin American developing countries can be explained by the role played by exports. There appears to be a strong relationship between export growth and real GNP: the faster the rise in exports the faster the growth in GNP. Much of the economic expansion of the East Asian countries has been founded on rapidly growing exports. For instance, South Korea's export volume rose by 15 percent a year between 1974 and 1984. With the exception of Mexico, where oil exports play a predominant role, the Latin American developing countries have been less successful in expanding exports and thus have experienced slower overall GNP growth.

GROWTH IN EXPORT VOLUME AND GNP

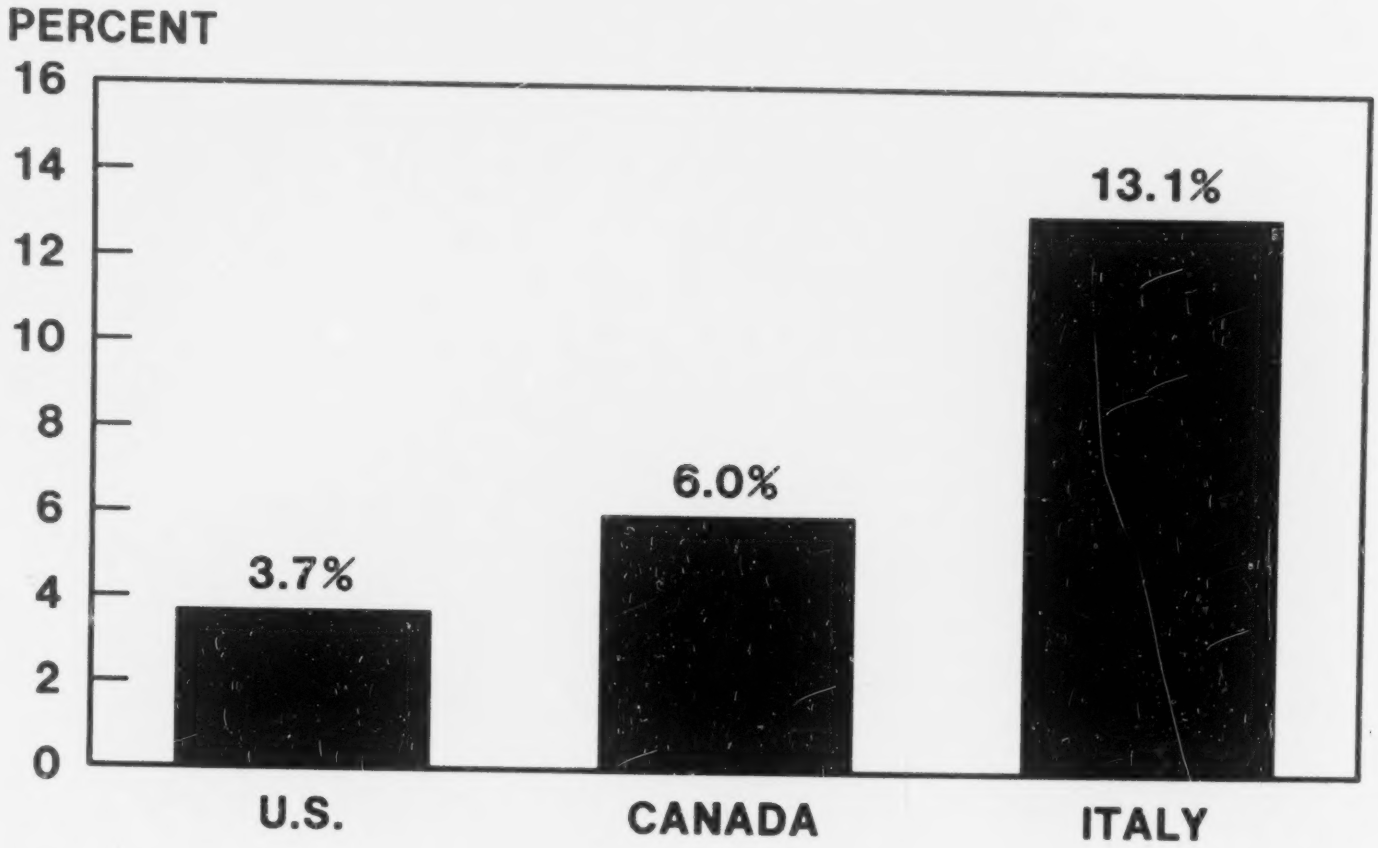
1974–1984



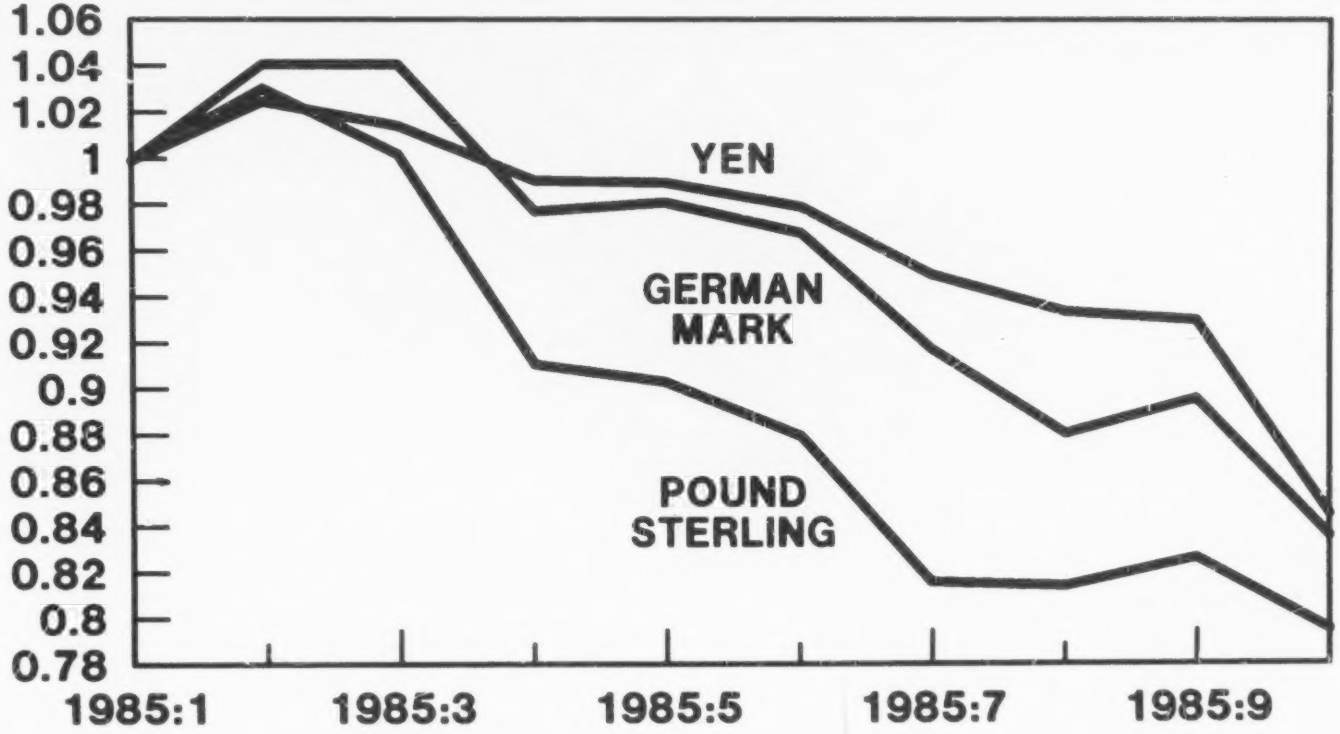
*1973–83

Sources: IMF Country Sources
The Economist, November 15, 1985

GOVERNMENT DEFICIT AS A PERCENT OF GNP



U.S. DOLLAR VS. SELECTED CURRENCIES
(INDEX, 85:1 = 1.0)



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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

December 1985

THE NEAR TERM OUTLOOK

by

Graciela Testa-Ortiz and Richard W. Rahn

The third quarter GNP growth figures were revised upwards by a full percentage point, bringing the economy's growth rate to 4.3 percent, the first time since the last quarter of 1984 that GNP growth reached the 4.0 to 4.5 percent range. The revisions reinforced the sources of strength during the quarter as both consumer durable spending and federal government purchases were increased, rising by 23.3 percent and 40.9 percent, respectively. Exports remained flat during the third quarter, but imports rose by 11.1 percent pushing real net exports to a $38 billion deficit. Investment, though slightly improved from the preliminary estimate, remained negative. Real business inventories rose by $2.5 billion rather than declining by $2.1 billion as had been originally reported. Residential investment rose by almost 12 percent, however, nonresidential declined by 3.8 percent.

Save for the incorporation of recently released data, our December forecast for the next two years remains largely unchanged from last month. The sharp slowdown in domestic car sales anticipated in the aftermath of the late summer sales incentives has already become apparent. Car sales averaged 6.3 million units in October and 6.5 million in November compared to an average of 8.7 million units during the first nine months of the year. Early December data are more encouraging as sales pierced the 7 million unit level for the first time since the financial incentives were discontinued. We expect that they will average only 6.8 million for the fourth quarter, contributing to a 19 percent decline in consumer durable spending. October consumer spending data already point to the depressing effect of the fall off in domestic automobile purchases. Personal consumption expenditures declined by 0.9 percent in October compared to increases of 1.1 percent and 1.2 percent in August and September, respectively. However, an examination of the detailed data shows that consumer demand remains strong. Almost all of the decline resulted from a 22.6 percent drop in the motor vehicles and parts component which pushed durable purchases down by almost 11 percent compared to the previous month. Spending on nondurables and services, on the other hand, rose significantly. In spite of the October decline, total consumption remains seven percent above the level reached in October 1984.

The consumer spending outlook remains bright. Personal income rose in October, recording its strongest gain in six months. The rise in personal income included an 11 percent increase in farm income and a 0.5 percent increase in wage and salary disbursements in the manufacturing sector, which had remained flat during the past six months. Personal income, particularly the wages and salaries component, should strengthen further in November to reflect improvements in employment. Civilian employment rose by 62,000 in November pushing the unemployment rate down to seven percent. The good news on the employment and income front is reflected in both consumer attitudes and retail sales. The University of Michigan consumer sentiment index rose to 90.9 in November from 88.4 in October. The November gain stemmed from improved prospects for the economy, with fewer participants anticipating increases in unemployment, inflation, or interest rates over the next 12 months. Retail sales increased by 1.2 percent in November following a 3.3 percent decrease in October and are now 5.1 percent higher than at this time last year. Largely as a result of the fall off in automobile purchases, we expect fourth quarter consumer spending to decline by 0.9 percent. However, this represents a one-time adjustment as we anticipate that consumer spending will continue to be a source of strength during the next two years.

IN THIS ISSUE

The Near Term Outlook .... p. 1
Forecast Table .... p. 2
Economic Impact of the House Ways and Means Committee Tax Reform Bill .... p. 4
The Benchmark Revision to the National Income and Product Accounts .... p. 6
The Search for a New International Monetary System .... p. 8
Manufacturing Trade and Productivity .... p. 13
Trends in Commerce .... p. 17

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TABLE I
UNITED STATES ECONOMIC OUTLOOK 1984-1987
Prepared by the U.S. Chamber of Commerce
Percent change from previous period at seasonally adjusted annual rates

	QUARTERS									YEARS			
	Actual			Forecast						Actual	Forecast		
	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	87:1	1984	1985	1986	1987
GROSS NATIONAL PRODUCT													
Real GNP	0.3	1.9	4.3	2.5	3.8	4.0	4.2	4.6	4.1	6.8	2.5	3.6	3.9
Consumption	5.2	4.9	5.3	-0.9	3.7	2.9	2.6	2.4	2.3	5.3	4.0	2.7	2.4
Residential Investment	5.5	6.1	11.6	6.0	8.5	8.0	7.4	4.3	-3.1	12.2	2.6	7.8	0.6
Business Fixed Investment	-1.5	14.4	-3.8	6.7	6.8	6.1	4.8	6.6	3.7	19.8	6.6	5.5	5.0
Equipment	-5.6	16.7	-3.7	6.9	8.4	5.1	6.5	6.6	3.7	21.5	5.8	6.1	4.7
Structures	9.8	8.8	-3.8	6.1	2.8	8.6	0.6	6.6	3.6	15.6	8.5	3.9	5.7
Exports	-8.9	-15.2	0.3	6.8	7.9	11.7	15.8	18.2	19.7	4.7	-4.1	7.4	15.8
Real Net Exports (72$B)	-28.4	-33.8	-38.4	-37.3	36.4	-34.6	-31.7	-28.1	-23.6	-15.0	-34.5	-32.7	-19.3
Imports	32.2	-0.7	11.1	2.7	4.1	5.2	5.7	6.4	6.1	27.0	8.3	4.9	5.7
Government Purchases	0.6	-0.3	40.9	-2.0	0.4	3.5	4.2	3.1	2.6	3.5	10.5	5.4	2.5
Real Final Sales	-0.3	4.6	5.7	0.8	4.1	3.9	3.9	3.9	3.3	6.0	3.5	3.6	3.4
Industrial Production	0.7	2.0	3.2	0.4	5.2	6.4	6.4	7.9	6.6	10.6	2.5	4.4	6.3
Change in Business Inventories (72$B)	19.1	8.3	2.5	9.5	8.5	9.1	10.7	13.7	17.1	24.8	9.9	10.5	20.3
New Car Sales (total, mill.)	11.2	11.0	12.7	9.9	11.4	11.5	11.7	11.9	11.8	10.4	11.2	11.6	11.7
New Domestic Car Sales (mill.)	8.5	8.2	9.4	6.8	8.2	8.2	8.2	8.3	8.2	8.0	8.2	8.2	8.1
New Housing Starts (total, mill.)	1.8	1.8	1.7	1.7	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	7.3	7.3	7.1	7.0	7.0	6.8	6.6	6.3	6.1	7.5	7.2	6.7	5.9
Compensation	5.0	3.5	3.7	3.5	4.3	4.1	4.1	4.3	4.7	4.2	3.9	4.0	4.5
Productivity	-3.3	1.1	1.5	2.3	1.5	1.4	1.3	1.5	1.1	2.7	0.3	1.6	1.1
Unit Labor Costs	8.6	2.4	2.1	1.2	2.8	2.7	2.9	2.8	3.6	1.4	3.6	2.4	3.4
Consumer Price Index	3.3	4.2	2.4	2.9	3.6	3.6	3.6	4.2	4.3	4.3	3.4	3.4	4.0
Implicit GNP Deflator	5.4	2.6	2.3	3.8	3.0	3.4	3.3	3.4	3.9	3.8	2.7	3.2	3.5
Prime Interest Rate (%)	10.5	10.2	9.5	9.5	9.1	8.9	8.8	8.7	8.6	12.0	9.9	8.9	8.0
3-mos. Treasury Bill Rate (%)	8.2	7.5	7.1	7.1	7.1	6.7	6.6	6.6	6.5	9.5	7.5	6.6	6.0
Corporate Bond Rate (%)	12.3	11.6	11.0	10.8	10.3	10.0	9.7	9.5	9.3	12.7	11.4	9.9	8.9
Real Personal Disposable Income	-1.6	8.1	-4.3	2.6	3.3	2.2	2.2	2.1	4.1	6.7	2.2	2.0	2.6
Profits from Current Production ($B)[1]	207.0	214.9	233.3	237.6	242.1	250.8	252.5	258.1	262.6	195.9	223.2	250.9	267.5
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts										666.0	736	788	860
Unified Outlays										842.0	937	980	1035
Unified Deficit										-176.0	-201	-192	-175

[1] After-tax corporate profits with inventory valuation and capital consumption adjustments.

[2] Unified budget figures on a fiscal year basis. 1985 data are actuals.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's revision to the National Income and Product Accounts for the third quarter of 1985. Congress is assumed to enact a deficit reduction package which results in a static reduction in federal government outlays of $44 billion in fiscal year 1986 and $684 billion in fiscal year 1987. The nation's money supply, as measured by M(1), rises by almost 9 percent in 1985, 8 percent in 1986 and 7 percent in 1987. The price of a barrel of imported crude oil averages $25 in 1986 and $24 in 1987 compared to $28.9 in 1984. The trade-weighted exchange value of the dollar rises 3.5 percent this year on a year-over-year basis. During 1986 and 1987, it falls by 14 percent and 5 percent, respectively.

Total housing starts for the first two months of the fourth quarter average 1.66 million units. Starts are estimated to average 1.8 million for 1985 as a whole, similar to 1984's level of starts. In spite of the slowdown in first quarter GNP growth, the housing market has been able to maintain a very healthy level of starts, consistent with demographic and replacement demand. Nevertheless, the rebound to higher levels that had been anticipated as a result of improved affordability has not materialized. We expect that the current pace of housing activity will be continued during the next two years.

Another positive sign is the upward revision to the leading indicators index for September, which posted a 0.4 percent rise rather than the 0.1 percent increase originally reported. In October, the leading indicators registered a further 0.3 percent increase, presaging further strength in the months to come.

The nonresidential investment sector has been marked by a see-saw pattern during 1985, reflecting the uncertainty resulting from the likelihood of the enactment of a tax reform program which will substantially reduce investment incentives. Nonresidential investment fell by 1.5 percent during the first quarter of this year, but rebounded sharply during the second quarter, posting a 14.4 percent increase. Revised third quarter data, however, showed a 3.8 percent shortfall in this category of investment. In spite of these recent ups and downs, nonresidential investment remains the recovery's stellar performer, having risen by 33.1 percent since the end of 1982, compared to an average increase of 20.6 percent during the past five recoveries.

Labor productivity, which declined by 3.3 percent during the first quarter of this year, posted two consecutive gains in the second and third quarters, rising by 1.1 percent and 2.1 percent, respectively. As a result, increases in unit labor costs will remain modest and help hold the line on product prices. Consumer prices will show a further deceleration in 1985, rising by only 3.4 percent compared to a 4.3 percent increase in 1984. While several factors, including moderate wage increases, low levels of capacity utilization, and, in particular, the anticipated drop of world oil prices, will help hold the line on consumer price increases, the decline in the value of the dollar is likely to offset these downward pressures. Higher import prices should contribute to a steady, albeit slow, acceleration in prices during 1986 and 1987.

The year-long decline in the foreign exchange value of the U.S. dollar continues. Since the end of February, the dollar has fallen by 25 percent against the West German mark, 22 percent against the Japanese yen, and 28 percent against the British pound. Although the decline in the dollar's value has yet to be translated into a rebound in U.S. exports, we expect that export growth will strengthen markedly by mid-1986 as the competitiveness of U.S. exports improves.

While the U.S. economy should continue to follow a path of healthy but moderate growth, the tax reform debate weighs heavily on that assessment. The article that follows presents the results of an econometric analysis of the Ways and Means proposal. While it is clear that passage of the House version into final law would significantly impair economic growth and greatly damage productive investment, it is now certain that tax reform will not be implemented until 1987, and that the Senate is likely to make major changes in the House bill. Without knowing the structure and implementation dates of the final tax bill, any 1987 forecast is subject to great change. It is also unclear as to what investor response will be after another six months of debate and uncertainty regarding capital cost recovery. Investment could be artificially stimulated if businesses believe their decisions will be "grandfathered," or it might be artificially retarded depending upon the uncertainty of tax treatment.

Passage of the Gramm-Rudman-Hollings balanced budget legislation came too late to be included in the current forecast. However, an independent study of the bill, performed by Laurence H. Meyer and Associates for the Center for the Study of American Business shows that "a smooth transition to a balanced budget. . .is possible." Assuming that the Federal Reserve accommodates the budget cuts required under this bill, ". . .real and nominal interest rates decline sharply, investment rises, the path of real GNP is unchanged, inflation is slightly higher, the dollar falls. . ., and the trade deficit is virtually eliminated by 1991."

The outlook under both of these fiscal policy changes depends significantly on the monetary policy response. Easier monetary policy following enactment of the tax reform proposal would mitigate its negative impact. However, it would still leave nonresidential investment on a lower path. Similarly, a move to restrictive monetary policy in the case of the balanced budget scenario worsens the economy's prospects.

Finally, as another article in this issue details, the release of the Department of Commerce's benchmark revision to the National Income and Product Accounts at the end of this time will result in significant changes to the data. Next month's issue of ECONOMIC OUTLOOK will incorporate all of the changes.

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ECONOMIC IMPACT OF THE HOUSE WAYS AND MEANS COMMITTEE TAX REFORM BILL

by

Richard W. Rahn

A recently completed econometric analysis of the House Ways and Means Committee's tax reform bill, performed for the U.S. Chamber of Commerce by the consulting firm of Laurence H. Meyer and Associates using the Washington University macro model of the U.S. economy, shows that implementation of the bill will result in significantly lower rates of economic growth.

TABLE 1

Impact of House Ways & Means Tax Reform Bill on the U.S. Economy

	Years from Implementation							
	1	2	3	4	5	6	Average Impact	Cumulative Impact
	1986	1987	1988	1989	1990	1991		
GNP								
Difference[1]	-3.0	-5.1	-14.0	-27.5	-41.5	-53.9	-24.2	-145.0
Percent[2]	-0.2	-0.3	-0.8	-1.4	-2.1	-2.7	-1.3	
Consumption								
Difference[1]	1.6	7.5	7.2	3.1	-3.3	-11.0	0.8	5.1
Percent[2]	0.1	0.6	0.6	0.3	-0.3	-0.8	0.1	
Nonresidential Investment								
Difference[1]	-4.1	-12.2	-22.0	-32.0	-40.8	-47.8	-26.5	-158.9
Percent[2]	-1.0	-5.2	-9.0	-12.4	-15.2	-17.1	-10.5	
Equipment								
Difference[1]	-3.6	-10.9	-19.4	-27.7	-34.7	-40.0	-22.7	-136.3
Percent[2]	-2.2	-6.3	-10.8	-14.6	-17.4	-19.0	-12.2	
Structures								
Difference[1]	-0.4	-1.3	-2.6	-4.3	-6.1	-7.8	-3.8	-22.5
Percent[2]	-0.7	-2.1	-4.0	-6.4	-8.8	-11.3	-5.7	
Residential Investment								
Difference[1]	-0.8	-0.4	0.4	0.1	-0.5	-1.2	-0.4	-2.4
Percent[2]	-1.3	-0.6	0.6	0.2	-0.8	-1.8	-0.6	
Exports								
Difference[1]	-0.1	-0.4	-1.2	-2.4	-4.1	-6.0	-2.4	-14.2
Percent[2]	-0.1	-0.3	-0.8	-1.6	-2.6	-3.6	-1.6	
Unemployment Rate								
Difference[3]	0.0	0.2	0.4	0.8	1.0	1.3	0.6	NA
Implicit Price Deflator for GNP								
Difference[3]	0.1	0.1	0.1	0.2	0.1	-0.2	NA	NA
Treasury Bill Rate								
Difference[3]	0.0	0.0	-0.1	-0.2	-0.3	-0.4	-0.1	NA
Corporate Bond Rate								
Difference[3]	0.0	0.0	-0.1	-0.1	-0.2	-0.3	-0.1	NA
NIA[5] Deficit								
Difference[4]	7.5	-11.7	-13.5	-18.9	-23.1	-25.3	-11.9	NA

[1] Difference from base in billions of real (1972) dollars.
[2] Percent difference from base.
[3] Percentage point difference from base.
[4] Difference from base in billions of current dollars.
[5] National Income Accounts.

Source: Laurence H. Meyer & Associates

The study estimates that the enactment of the bill would result in a cumulative decline in real gross national product of $145 billion between 1986 and 1991. The nonresidential investment sector will suffer a $158.9 billion cumulative decline as the after-tax cost of capital investment rises substantially. Most of this decline is borne by investment in producers' durable equipment which falls by a cumulative $136.3 billion over the six year period. U.S. exports are projected to fall by $14.2 billion, while consumer spending enjoys a small $5.1 billion increase.

Both the civilian unemployment rate and the federal budget deficit would rise if the House bill is enacted as currently written. In 1991, the unemployment rate will be 1.3 percentage points higher than if the bill were not enacted, and civilian employment would fall by a cumulative 4.5 million jobs. Similarly, the federal budget deficit will be $25.3 billion (current dollars) higher than under present law.

Simulation Detail

While the U.S. economy is expected to continue on a path of relatively healthy growth under current tax law, this outcome will not be achieved if the House Ways and Means tax reform bill is enacted. The bill returns to a depreciation system similar to the Asset Depreciation Range (ADR) that was in effect prior to the enactment of the Economic Recovery Tax Act of 1981. The changes in depreciation made by the Administration's 1981 tax program have been credited as being a major contributing factor to the strength of investment growth during the current recovery. Moreover, the Ways and Means proposal includes higher capital gains tax rates, corporate tax increases and other items which will reduce U.S. economic growth.

The accompanying tables and charts compare the impact of this bill on the national economy to the baseline forecast of the Congressional Budget Office (CBO). The after-tax cost of capital for equipment, residential buildings and consumer durables is expected to rise significantly if the House bill is enacted (see Table 1). Consequently, substantial declines in investment, particularly investment in producers' durable equipment, will result in significantly lower rates of economic growth and higher unemployment (see Table 2). The plan would result in average annual increases in economic activity of only 2.9 percent during the next six years compared to a projected growth rate of 3.5 percent under present law.

Detailed results of the simulation are as follows:

- Real gross national product would suffer a $145 billion cumulative loss between 1986 and 1991 than would otherwise have been the case (see Chart 1). Averaging $24.2 billion per year, the declines in economic activity range from $3 billion during the first year to $53.9 billion by the

TABLE 2

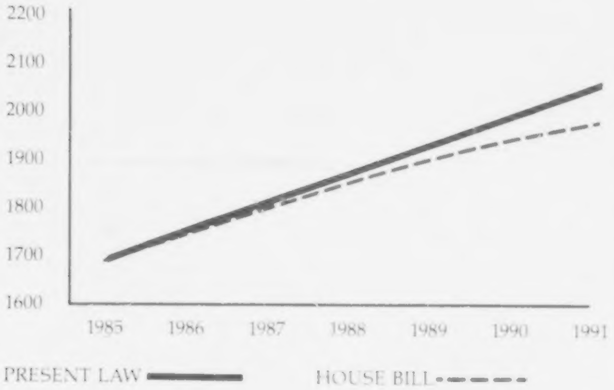
Impact of House Ways & Means Tax Reform Bill on the Rental Price of Investment (percent difference from base)

	Years from Implementation					
	1	2	3	4	5	6
	1986	1987	1988	1989	1990	1991
Business Capital						
Equipment	18.3	18.1	17.6	17.8	17.7	17.4
Structures	11.3	10.7	9.8	9.2	8.7	7.7
Residential Buildings						
Single Family	4.2	4.5	3.7	3.7	2.9	2.2
Multi Family	7.3	7.2	0.6	6.5	6.4	5.1
Consumer Durables	1.4	1.0	1.0	1.0	0.5	0.5
Inventories	1.4	0.0	-1.5	-3.2	-4.8	-5.0

Source: Laurence H. Meyer & Associates

CHART 1

IMPACT OF HOUSE BILL ON REAL GNP
(Billions 1972 $)



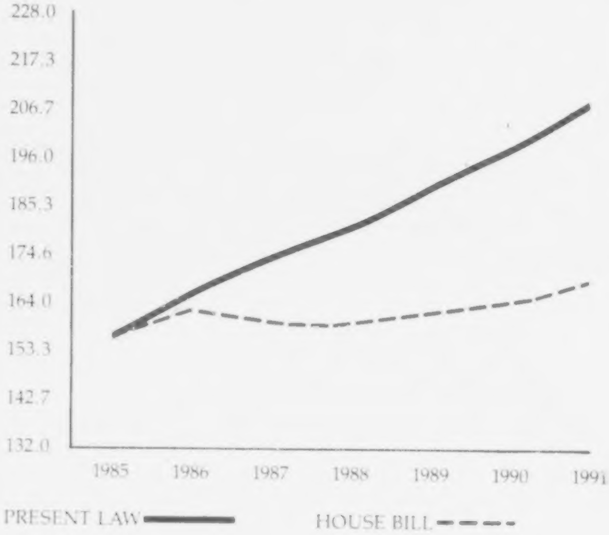
sixth year after implementation of the tax reform plan.

- Because individual tax rates would fall but the effective corporate tax rate would rise, the composition of gross national product shifts away from investment toward consumption. As a result, real consumer spending would account for 65.8 percent of total output compared to 64.6 percent under present law. On the other hand, nonresidential investment falls from 13.8 percent of total GNP under present law, to only 11.7 percent under the House bill. While consumer spending rises by a cumulative $5.1 billion during the six years following implementation of the bill, the bulk of the increase in consumption occurs during the first four years after the plan is enacted. During the fifth and sixth years following implementation of the House bill, real consumer spending falls by a cumulative $14.3 billion as the decline in investment results in higher unemployment and a lower standard of living for all Americans.

- Increases in the after-tax cost of capital investment contribute to a cumulative $158.9 billion decline in nonresidential investment during the six years following implementation of the bill. The bulk of the deterioration is borne by the producers' durable equipment sector which suffers a cumulative decline of $136.3 billion, or an average yearly shortfall of $22.7 billion (see Chart 2). Investment in nonresidential structures falls by $22.5 billion during the same period, while residential investment declines by $2.4 billion.

CHART 2

IMPACT OF HOUSE BILL ON PRODUCERS' DURABLE EQUIPMENT
(Billions 1972 $)



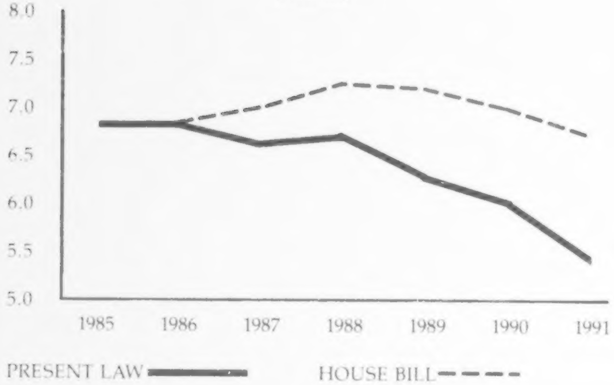
- By sharply increasing domestic capital costs and reducing domestic investment, the House bill will worsen the competitive position of U.S. goods. Consequently, real exports suffer a $14.2 billion cumulative decline between 1986 and 1981.

- The American economy's ability to create new jobs has been the envy of the industrialized world. By restricting investment, the House bill will seriously hamper the U.S. economy's ability to create new jobs. Consequently, the civilian unemployment rate is higher throughout the simulation interval (see Chart 3). In 1991, the unemployment rate is 1.3 percentage points higher than would otherwise have been the case.

- Enactment of the House bill does not have a significant impact on inflation and interest rates. The implicit deflator for GNP is approximately one-tenth of a percentage point lower under the House alternative. Similarly, both short- and long-term interest rates are, on average, only 10 basis points lower.

- The House bill will also have a negative impact on the federal deficit. Although the bill is structured to be revenue neutral on a static basis, this ignores the dynamic interaction between economic activity and government

CHART 3
IMPACT OF HOUSE BILL
ON UNEMPLOYMENT RATE
(Percent)



receipts and expenditures. Lower rates of economic growth reduce the tax base, and as a result, lower receipts, while higher unemployment increases expenditures. Consequently, in 1991, the federal deficit is $25.3 billion higher than under current CBO assumptions.

Strong rates of economic growth are essential for job creation and an improved U.S. standard of living. The Ways and Means Committee bill will clearly slow the economic recovery we are now enjoying.

THE BENCHMARK REVISION TO THE NATIONAL INCOME AND PRODUCT ACCOUNTS

by
Graciela Testa-Ortiz

On December 23rd, the Department of Commerce will release its comprehensive, or benchmark revisions of the National Income and Product Accounts (NIPA). These revisions are the occasion for major changes in the data, not merely updates of previous estimates. The 1985 revisions will include statistical and methodological changes and alterations in definition and classification of several variables. All the series in the National Accounts will be revised beginning in 1973, and a substantial number of them will be revised back to 1929. What follows is a detailed description of the revisions and their likely effect on measured GNP.

Statistical and Methodological Changes: Shifting the Base Year

The statistical changes are the most important revision taking place this year. They reflect efforts to develop and update data sources and estimating techniques to deal with long-recognized shortcomings in the reporting of national income and product. The major statistical revision involves the shift in the base year period for calculating inflation-adjusted national income and product components. Heretofore, adjustment for the impact of inflation was based on 1972 prices and the 1972 composition of output. The revision will shift that base year to 1982. All the relevant constant dollar (i.e., inflation-adjusted) data will be recalculated back to 1929 in terms of 1982 prices. Fixed-weight price indices, which report price changes based on the composition of output in the base year, will also be recalculated so that weights reflect the 1982 composition of output. The fixed-weight and implicit price deflators will, from now on, have the year 1982 equal to 100. The shift from the 1972 base year to 1982 will result in more accurate measures for real output and prices. The rationale behind this shift is that economic changes since 1972 have resulted in a shift in spending patterns. In general, purchasers have shifted their preferences away from items which experienced large price increases to those which experienced smaller increases or declines in prices.

Department of Commerce calculations show that as a result of this shift, the rate of change of both GNP and the fixed-weight price index will decline. The shift in the base year will reduce the growth rate in real GNP, which averaged 2.7 percent between 1972 and 1984, by about 0.4 percentage points per year. The fixed-weight price index, which has risen at a 7.3 percent annual rate will be reduced by about 0.3 percentage points per year.

Statistical and Methodological Changes: Investment in Computers

Another statistical change includes the introduction of a price index for the deflation of computers. The lack of a deflator for computers implies that, up until now, the national income and product accounts have assumed no price change for computers (including central processors and peripheral equipment). However, preliminary evidence indicates that the prices of computers, which are included in investment in producers' durable equipment; declined at an average annual rate of over ten percent between 1970 and 1984. As a result, the inclusion of this new index, taken alone, would substantially raise the level and rate of change of producers' durable equipment *in 1972 dollars*. However, when this change is combined with the shift in the base year to 1982, the effects of these two changes are likely to offset each other.

Statistical and Methodological Changes: The Underground Economy

The major methodological change which will be made to the accounts involves improved adjustments for misreporting on tax returns. This change is expected to be quite large and to affect both the income and product components. The underground economy is not totally ignored by the National Income Accounts, in fact, they already include an adjustment for misreporting—a major manifestation of the underground economy. The improvement which will now be implemented involves the introduction of newly available data on the extent of misreporting and nonfiling. The adjustment will be substantial. For instance, for the year 1977, it represents an $11.3 billion increase in compensation of employees, a $46.5 billion increase in proprietors' income (including inventory valuation and capital consumption adjustments), a $21.6 billion increase in personal consumption expenditures, and a $0.2 billion rise in private domestic investment.

Other data improvements include the following:

- Other labor income will be revised back to 1973 and will include a revised series on employer contributions for health insurance. This adjustment reflects a more accurate accounting of premiums paid by employers for health insurance administered by third parties and constitutes a substantial increase to this category of income.

- Improved accounting for homeownership expenses involves the inclusion of all types of expenditures considered ordinary and necessary as business deductions under federal income tax regulations. This adjustment will bring homeownership expenses into line with estimates of corporate profits and proprietors' income. The effect of this change will be to reduce rental income.

- The proprietors' income category of personal income will be adjusted to eliminate the portion of partnership income attributable to corporate partners which already appears in corporate tax returns. Without this adjustment the income of corporate partners would be counted twice, once as proprietors' income and again as corporate profits. The effect of this change is to reduce proprietors' income.

- Improved estimates of investment income of private noninsured pension plans will raise dividends received, and thus the rental income of persons. Similarly, because dividends received by these plans are netted against dividends paid, corporate profits will be reduced.

- Improved estimates of investment for electrical utilities will incorporate a new procedure that takes into account the fact that nuclear power plants have a lower share of structures and a higher share of equipment than other electric power plants. The effect of the change will be to reduce investment in structures for most years beginning in 1968.

- Improved estimates for residential investment will affect single-family housing and additions and alterations for owner-occupied dwellings. The construction value for single-family homes has been redefined to include land development done by the builder. For additions and alterations to owner-occupied dwellings, the change in methodology involves the incorporation of new data and will raise this estimate.

- At present, there exists a discrepancy in the geographic coverage of exports and imports in the GNP accounts with that found elsewhere in the national income accounts. Henceforth, these will be brought into line by excluding the Commonwealth of Puerto Rico and U.S. territories from exports and imports. The effect of this change will be to raise exports, imports, and net exports.

Changes in Definition and Classification

Changes in definition and classification are made so that the accounts will reflect the economy's evolving institutions. For example, several of the changes are intended to reflect more accurately the nature of government programs. There will be nine changes of this nature, six of which will affect total GNP. These changes include the following:

- Outlays for replacement railroad track will be added to investment in nonresidential structures, thus raising GNP.

- Outlays for replacement of major items (such as the roof or heating system) in residential buildings will be added to residential investment, raising GNP substantially.

- A social insurance fund for military retirement will be imputed. It will be included as part of employee compensation in charges against GNP, but will also be added to the national defense purchases portion of the GNP account, thus making a sizeable contribution to raising the estimate for GNP. However, because the contribution will be added to both federal receipts and expenditures, the deficit will not be affected.

- A social insurance fund for federal unemployment insurance for military personnel will be imputed. This charge will be treated as the imputed military retirement fund mentioned above, and will have no net effect upon the deficit. However, as with the military retirement fund, the resulting increase in defense purchases will raise GNP.

- The Civilian Health and Medical Plan of the Uniformed Services (CHAMPUS) will be treated as an employer-paid health insurance plan. CHAMPUS expenditures constitute an addition to employer contributions in charges against GNP and an increase in national defense purchases. Further, benefits paid under the program will be included in transfer payments in the personal income account, and reclassified from government purchases to personal consumption expenditures for medical services in the GNP accounts. The federal deficit will not be affected by these changes.

- A bank service charge to foreigners will be imputed. This charge will be added to exports of services other than factor income and an offsetting imputed charge will be added to imports of factor income services so that net exports will not be affected. However, the portion reallocated to foreigners will be taken out of personal consumption expenditures and as a result, will reduce measured GNP.

- Military shipments financed by so-called forgiven loans will be reclassified: added to exports of goods and services and removed from national defense purchases. As a result, measured GNP will not be affected.

- Reimbursements by government to providers of medical services under several programs, including Medicaid, will be treated as transfer payments under personal income. Reimbursements to state and local hospitals will be considered fees and treated as personal nontax payments, reimbursements to other providers will be added to personal consumption expenditures for medical services and removed from state and local government purchases. Although total GNP will not be affected by this change, the composition of GNP will shift as government purchases are reduced substantially and personal consumption expenditures are increased by an equal amount.

- Payments under two state and local government assistance programs (those made to energy suppliers on behalf of low-income persons, and payments made to crime victims), will be reclassified from state and local government purchases to personal consumption expenditures within GNP.

New Tables

Changes will also be made to the national income and product account tables in order to reflect these revisions. Two new tables will be added which will provide a better accounting of the relationship between domestic output and demand, and of the increasing importance of foreign trade to the U.S. economy. One of these tables will show the relation between GNP, gross domestic purchases, and final sales to domestic purchasers. This information is designed to emphasize the relation between GNP – a measure of production – and the other two variables which represent measures of aggregate demand. Gross domestic purchases is defined as GNP less exports of goods and services plus imports of goods and services, and represents U.S. purchases of goods and services regardless of where they are produced. Final sales to domestic purchasers is defined as gross domestic purchases less the change in business inventories and represents U.S. sales regardless of where they originate.

Another new table will include command-basis GNP. This measure is defined as gross domestic purchases plus command-basis net exports. Command-basis exports is exports deflated by the implicit price deflator for imports. Thus, command-basis GNP represents gross national product adjusted for changes in the terms of trade and measures what the U.S. could purchase with its production.

Conclusion

While benchmark revisions such as the current one create major headaches for economists, particularly those of us involved in forecasting, as is obvious from the details provided, they imply a dramatic improvement to the data, and, as such, are quite welcome. However, the revisions mean that a large part of the comparative analysis that you have read in these pages will need to be revised. As a result, future issues of the OUTLOOK will re-examine such issues as the relative performance of this recovery compared to previous episodes, the composition of GNP, in particular, with regard to federal expenditures and receipts, and the investment share of total U.S. output.

THE SEARCH FOR A NEW INTERNATIONAL MONETARY SYSTEM

by
Ronald D. Utt

This last year has been a rough one for monetarist economists like ourselves who, with great confidence, predicted that the 1985 economy would be much stronger than it turned out to be. Throughout the year, our unflagging optimism followed from our belief that the rapid growth in the money supply that began in October, 1984, would lead to strong economic growth and higher rates of inflation in 1985. Although growth did pick up in the latter part of the year, it came later and was of more modest proportions than we had earlier projected.

The failure to forecast the slow growth this year is just one of several events that challenged monetarists in 1985. Another is the now near universal dissatisfaction with the existing system of flexible exchange rates – a financial arrangement advocated and supported by mainstream monetarists. Not surprisingly, this growing disenchantment has led to an aggressive search for alternatives both domestically and internationally. And as the search progresses, favorable comments are raised, often from unexpected quarters, about the advantages of a system of fixed exchange rates, and a gold-backed monetary arrangement.

II

The Roots of Our Current System

Our current system was born of a series of financial crises in the 1960s which came to a head in 1971 when the United States, unable and unwilling to maintain the value of the dollar at its then fixed rate, severed the last remaining link between the dollar and gold and allowed it to float on international currency markets. Within days, the dollar plunged nearly ten percent against major currencies and a new world monetary order emerged. With gold officially demonetized, the world monetary system embarked on a new series of international trade and monetary arrangements that most then believed would resolve the problems that periodically plagued the international economy as it attempted to function under a fixed rate exchange system.

Under the old system of fixed exchange rates, currencies were linked to one another by a series of fixed relationships that determined how much of one currency would purchase another. Modest variations of a few percentage points up and down were permitted but once the upper or lower limit was reached or exceeded, intervention by central banks was required as the first step in the process of restoring the established relationships. For example, if the value of a currency, say the British pound, fell against the dollar and reached its lower limit, the British and American central banks would sell dollars and buy pounds until the dollar/pound exchange rate was restored. The converse would occur if the pound rose against the dollar.

If intervention failed to restore the designated exchange rates, then more fundamental corrective actions were required. To the extent that domestic economic problems, such as inflation, were the source of the divergence from equilibrium, then the country whose currency diverged from the predetermined relationship was compelled to alter its domestic economic policies to restore the established alignment. If, for example, the depreciation of the pound against the dollar was due to a British inflation rate that exceeded that of its trading partners and led to a deterioration of the terms of trade at the existing exchange rate, then the British government would be required to adopt restrictive monetary and fiscal policies to alter the fundamentals (divergent rates of inflation) until the established exchange rates were restored. In the short run, the tighter monetary policy would cause British interest rates to rise and encourage foreigners to buy pounds to purchase pound-denominated financial instruments that were, as a result, providing attractive interest yields. By encouraging the demand for pounds, this action would lead to a rise in the pound's value. For the longer run, the tighter monetary policy would lead to lower inflation, thereby restoring the terms of trade at the original exchange rate.

If this failed to restore order, or if the needed domestic policy changes could not be made, then the declining currency would be formally devalued and a new set of equilibrium exchange rates would be established. By these mechanisms, the world monetary system functioned from the time of the Bretton Woods exchange rate accord in 1944 to 1971 when President Nixon severed the dollar's link to gold and permitted it to float freely in international currency markets.

All through this period, the United States and the dollar held a special role in world financial markets that accorded both unique privileges. Because the price of gold was fixed, rapidly expanding world trade and the need to finance it required that the dollar serve the role of a reserve currency and a key medium of exchange in most international transactions. By assuming such a role, the United States was essentially free of any requirement to maintain domestic policies consistent with a given set of exchange rates. Because a growing world economy required a growing supply of dollars, the United States could run persistent deficits in its accounts with the rest of the world without having to worry about a decline in the value of the dollar relative to the currencies of our trading partners. For much of this period, the world was eager to hold as many dollars as we were willing to supply.

While the benefits from the dollar's unique status as the world's currency were many (and also a source of friction to some of our trading partners), it was a system that imposed no discipline on our economy. As a consequence, we could engage in policies that, while harmful to our long-run economic well-being, led to no discernible problems in the short run. Whereas a persistent pattern of rising inflation and declining competitiveness would have quickly forced the British or the French to take corrective action to preserve the value of their currencies and restore their terms of trade, no such forced corrective actions confronted the United States because the excess dollars were readily absorbed by the rest of the world.

Although the dollar's value did fall in the weeks following the agreement, it is not at all clear how much of this was due to the intervention. The sum of $10 billion over a period of six weeks is not much money for a market in which U.S. banks alone trade more than $40 billion on a daily basis. Moreover, the dollar had been falling in value over the seven months prior to the September intervention. Chart one below depicts the trade-weighted value of the dollar for the last two years and notes the point of combined intervention.

Chart two depicts the value of the dollar compared to three key currencies. In each case, it is obvious that the dollar had been falling steadily well in advance of the formal intervention.

Second, if high budget deficits lead to currency overvaluation in one country, then this phenomenon should

CHART 1
EXCHANGE VALUE OF THE DOLLAR
(Trade-Weighted Average)

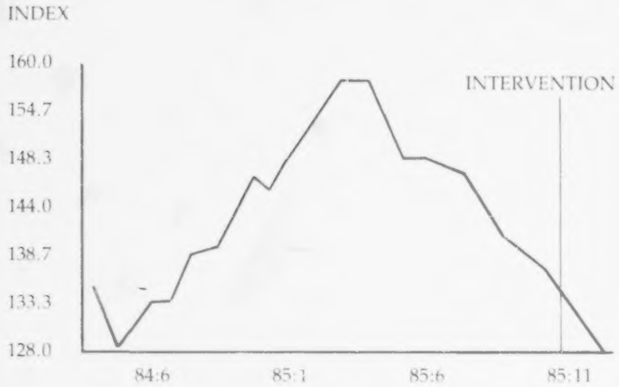
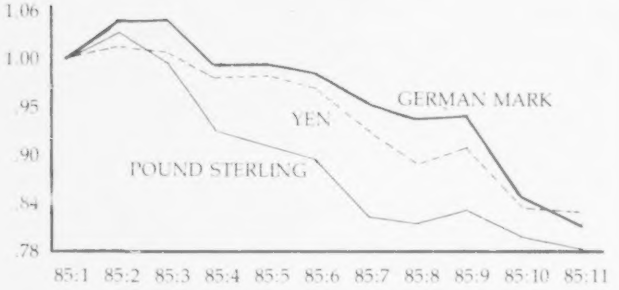


CHART 2
U.S. DOLLAR PER SELECTED COUNTRIES
(Index, 85:1 = 1.0)



be repeated in other countries where the same conditions prevail. It is not. Canada and Italy, for example, with government budget deficits that are significantly higher than ours as a share of their GNP, have seen the value of their currencies fall sharply against the dollar and other key currencies. And while the U.S. budget deficit is high by our historical standards, as a share of GNP it is not much different than the average deficit/GNP share for leading industrial countries. Thus, the facts suggest that we have to look elsewhere for the source of the problem.

The Monetary Policy Link

Dissatisfaction with the budget deficit theory of exchange rates has led many to begin a closer examination of the link between monetary policy and the value of the dollar. Inasmuch as it was the desire of the key industrial nations to maintain independent monetary policies, which they have done, such independence and divergence will lead to substantially different exchange rates over time to the extent that monetary policies differ from one another and that these differences change over time.

Looking at the last twenty years, the broad trends in the dollar's value (and other currencies as well) track inflation rates fairly well, and since inflation is a monetary phenomenon, these trends closely follow monetary policy developments too. From the late 1960s through 1980, an increasingly stimulative monetary policy contributed to accelerating inflation for much of the period. Concomitantly, as the domestic price level rose relative to that of other leading nations, the value of the dollar fell against their currencies. This trend was reversed in 1981 when the monetary brakes were applied and the U.S. inflation rate began to tumble. By 1983, the U.S. rate of inflation had fallen to less than a quarter of its 1980 rate of increase. Because this rate of improvement was far better than that of most leading industrial nations, the dollar's value reversed course and began to gain against most other currencies, peaking in early 1985 when industrial country inflation rates began to converge at the three to five percent range.

Added to these broad macroeconomic trends are a number of other financial factors that are working to keep the dollar's value high relative to other currencies. Coinciding with the rapid improvement in the domestic inflation outlook was an equally dramatic improvement in the domestic investment outlook as a result of the 1981 tax cuts and the booming economy. As economic opportunity increased at home, U.S. investors redirected their funds to the domestic economy from other parts of the globe. Our net capital outflow, which averaged over $100 billion per year in the first few years of this decade, fell to only $20 billion in 1984 for a net decline of over $80 billion. However, because the dollar serves as a reserve currency in world finance and is often the medium of exchange in trade between other countries, this massive decline in the supply of dollars led to an increase in its value as foreigners continued to demand the same amount of dollars. Something had to give, and that something was the merchandise trade deficit which soared from $40 billion per year in the late 1970s to an estimated $150 billion in 1985 in response to the highly valued dollar and the world's need for an adequate supply of dollars.

Regardless of how limited or successful the currency intervention has been, it marks an important change in U.S. attitudes toward the international exchange system and opens the way to serious consideration of even more fundamental changes in the system. The very fact that the five leading nations agreed to intervene to alter exchange values implies that they reject market-determined values and are attempting to establish a set of exchange rates more to their liking. Once this revaluation is established, it is only logical to assume that subsequent efforts will be devoted to maintaining it. And should this occur, the five nations will have established, in effect, a system of fixed exchange rates.

What is unique about this seemingly inevitable series of events is that it is occurring without any formal public discussion about alternatives for reform or whether a major change is even desirable. Granted, the current system is creating increasingly difficult problems for major segments of our economy. Nonetheless, it is not clear whether this is due to the exchange system itself or whether other, more fundamental sources, such as budget deficits and/or monetary policy, are to blame.

The Fiscal Policy Link

One of the most commonly held views of our exchange rate problem blames the sharp rise in the dollar's value on the budget deficit and the demands it makes on U.S. financial markets. The argument runs this way: The need to finance large budget deficits raises real interest rates (the nominal interest rate less the expected rate of inflation) in the United States, and this attracts capital from around the world. The increase in the demand for U.S. assets increases the world demand for dollars and the dollar's value rises relative to other currencies. In turn, the more expensive dollar makes our exports less competitive and holds down the price of imported goods, thereby increasing the U.S. trade deficit. Finally, this gap between exports and imports supplies the world economy with the volume of dollars it demands to invest in the U.S. economy.

While intuitively plausible, the argument suffers from a number of important defects. First, there is no evidence whatsoever that budget deficits lead to high interest rates. A host of studies have been undertaken in recent years to determine the link between budget deficits and interest rates and virtually all of them have failed to find any significant relationship. Indeed, historical evidence seems to offer more support to the opposite proposition. By taking away this crucial first link, this elaborate chain of deductive reasoning falls apart.

Such an arrangement, however, could not go on forever. By the late 1960s, the dollar glut was becoming unmanageable and our trading partners were becoming increasingly resentful of our ability to avoid the need for adjustment and of our ever expanding investment in their economies which was funded with a chronically overvalued dollar. At the same time, the overvalued dollar made U.S. products increasingly uncompetitive and gave rise to an aggressive protectionist movement in this country. This system finally came unraveled when foreign central banks refused to absorb any more dollars and insisted that the United States exchange gold for the dollars they held. Unable to cover the surplus of dollars with gold, we suspended the gold/dollar link and floated the dollar. Thus ended twenty-seven years of fixed exchange rates, a system which most economists and public officials at the time were more than willing to abandon.

At the time of its demise, the general consensus was that the Bretton Woods accord was a system that had outlived its usefulness. The periodic balance of payments crises that afflicted one country or another over the period were viewed as too high a price to pay to preserve a system that was supposed to facilitate trade, not hinder it. Yet, because of the need to maintain the exchange rates and the unwillingness or inability of most countries to adopt the dramatic domestic policy changes needed to restore exchange rate equilibrium, one country after another resorted to all manner of restraints on trade and financial flows in an attempt to keep the system together. In a world trading system characterized by widely divergent public policies and equally dramatic differences in economic performance, the fixed exchange rate system of the postwar era offered no workable adjustment process to the disequilibrium that occurred with increasing frequency.

In adopting flexible exchange rates, the world moved from a system which offered few opportunities for smooth adjustment to one that was in a constant state of adjustment. As various measures of domestic economic performance among the world's trading nations diverged, the exchange rates that tied them all together adjusted effortlessly to the changes. Whereas in the past deteriorating economic performance and/or above average inflation would have forced a country into a serious balance of payments crisis and required harsh restraint on its domestic economy, the new flexible exchange rate system merely altered the exchange rates to accommodate the new realities. Thus, each country was able to pursue its own domestic policies without having to worry about international repercussions or severe balance of payments disequilibrium.

For awhile, it appeared that flexible exchange rates offered everything the world trading system could possibly want. International trade in goods and services expanded rapidly, barriers to imports declined and the pervasive system of capital controls was quickly removed. As measures of economic performance diverged, so did exchange rates, and this adjustment process allowed countries to pursue their domestic policies independent of international considerations. If one country's inflation rate was higher than the others', its exchange rate fell relative to the other currencies in order to offset the decline in competitiveness that would otherwise have followed from the higher product prices.

Although the new system clearly worked to facilitate trade and capital flows, some analysts, in the late 1970s, began to detect an unintended side effect of flexible exchange rates that was becoming every bit as menacing to the world economy as were the problems associated with the system of fixed rates. What these analysts discovered was that the severing of the balance of payments from the domestic economy removed one of the most compelling reasons for a country to act responsibly in its domestic policies. Inflation, for example, or declining competitiveness due to a hostile tax system or increased regulation, would no longer lead to a deterioration in a country's terms of trade. If a country's products became less competitive in the world market, then its exchange rate would quickly adjust to reflect this and more or less maintain balance in its external accounts.

Looking back on the decade of the 1970s, many have come to view it as a period of license in domestic policymaking. In most countries, governments expanded their involvement in the economy and almost universally adopted inflationary monetary policies now that they were free of the balance of payments constraint. In the United States, domestic prices rose by 95 percent in the 1970s compared to 33 percent in the 1960s. And as productivity growth slowed and turned negative toward the end of the decade, unit labor costs soared. Despite all this, by the end of the decade the United States still managed to hold on to a trade surplus, in part because the trade-weighted value of the dollar declined by 27 percent over the period.

In effect, critics of the existing system argue that the advent of flexible exchange rates permitted the United States to maintain counter-productive inflationary policies for a decade longer than would have been the case under a fixed exchange rate regime. Confronted with what amounted to an international rejection of our domestic policies in the early seventies, the Nixon Administration side-stepped the need to make fundamental changes in monetary policy and, instead, floated the dollar and closed the gold window. Inflation was "attacked" by the imposition of wage and price controls, the first time such controls were imposed in peacetime. By 1973, the game plan fell apart and was followed by a severe recession and worsening inflation. A period of economic stagnation set in and was not reversed until the Federal Reserve reflated under the Carter Administration. This, in turn, led to the accelerating inflation of the late 1970s which was not reversed until the early 1980s, and then only at tremendous costs to the economy.

Although the worst of the inflation is behind us and central bankers seem to have learned to maintain a noninflationary monetary policy, this change in policy has not led to the exchange rate stability that most expected to follow from a more stable and responsible monetary policy. Indeed, precisely the opposite has occurred. Since 1980, the value of the dollar has been even more variable against other currencies than it was during the previous decade. By one measure, the value of the dollar on international currency markets was 60 percent more variable between 1981 and 1985 than it was between 1971 and 1980.

For most of the latter period, the dollar has moved in one direction – up, and this rapid appreciation has created a great deal of hardship among American manufacturers, farmers and workers, contributed to a quintupling of our merchandise trade deficit, and turned us into an international debtor. Of course, the dollar's appreciation was not without benefits. Inflation is lower, consumers are confronted with more product choices at lower prices, and many businesses have actually benefited because of cheaper, imported factor inputs. On balance, however, the capricious nature of the distribution of costs and benefits should be viewed with alarm, and the inability to predict future currency values makes a hash of business planning and long-term investment decisions.

The Search for Solutions and the Trend Back to Fixed Exchange Rates

As severe trade-related problems confront one domestic industry after another, public officials and the business community have embarked on a search for solutions. Early on, many of the alleged solutions that were proposed involved one form of protectionism or another. Ranging from outright tariffs, to quotas, and to domestic content requirements, the focus was on protecting domestic industries and products from foreign competitors. At present, something in excess of 300 pieces of protectionist legislation have been introduced in this session of Congress. Similarly, the President has, over the past several years, used his authority under a variety of trade laws to place limits on imports of some foreign products on a selective basis. Although the protectionist solution has intense support from certain segments of the economy, most Americans recognize it for the counterproductive approach that it is.

More recently, a growing number of policy analysts have begun to focus on the system of floating exchange rates and the accompanying monetary policy as the real culprits contributing to the high value of the dollar and the impact this has had on our world trade position. After years of defending the floating rate system and justifying a hands-off attitude, the Administration, through the U.S. Treasury and the Federal Reserve, has begun to directly intervene in currency markets in an effort to diminish the value of the dollar.

On September 22, 1985, the United States, Britain, West Germany, France and Japan agreed that other major currencies should "appreciate" against the dollar and that currency market intervention and changes in domestic economic policies would be used to achieve this objective. Over the next six weeks, these nations sold more than $10 billion in an effort to lower the dollar's value. Between late September and early November, the dollar declined 13 percent against the deutsche mark and 16 percent against the yen. Supporting domestic policy changes included an increase in Japanese interest rates to further encourage the demand for yen.

At the same time, there is evidence to suggest that the demand for money (dollars) in the domestic market increased significantly during the same period. The source of the change was the decline in the rate of inflation and the advent of regulatory innovations in the banking system which altered the public's willingness to hold money in the form of checking accounts and cash. If such a change did occur, it would have altered the otherwise predictable relationships between changes in the money supply and changes in economic growth, prices and exchange rates.

The key piece of evidence that such a shift in the demand for money has occurred is the very substantial slowdown in the growth of M1 velocity since 1982. As a measure of the turnover of the money supply to GNP in the economy, a decline in velocity indicates an increase in the demand for money. Such shifts in the demand for money are difficult to predict and can only be measured long after they have occurred. But when they do occur, they disrupt what is otherwise a stable and predictable relationship between the money supply and economic activity. Without an offsetting increase in the money supply, an increase in the demand for money can have a depressing effect on the economy. Because velocity has fallen below its trend in three of the last four years, monetary policy since 1982 may have been considerably more restrictive than the growth in the money supply indicates.

Thus, what appeared to be an expansive monetary policy since late 1984 may, in fact, have been one of restraint because increases in the money supply were quickly sopped up by increases in demand. If so, this would explain why the economy never took off in 1985 despite the apparent monetary stimulus, and why the rate of inflation continues to decline at a time when most monetarist economists expected it to increase. And finally, since exchange rates are influenced by domestic monetary policy, this also explains why the dollar rose to such lofty levels in the early part of the year and why it has declined so grudgingly since then.

Other Factors Contributing to the Dollar's Value

Like any other economic occurrence, the sharp rise in the dollar's value cannot be attributed to a single event, policy or relationship. In addition to monetary policy and whatever contribution the budget deficit may have made, other factors that have contributed to the rise include the powerful recovery in the U.S. and the investment opportunities it has created, the severe debt problems of the developing countries that have encouraged international investors to look elsewhere, the anemic recovery in much of Europe, and the faulty economic policies of several European countries which have served to depreciate their currencies against the dollar.

Conclusion

Although there is considerable debate about the causes of the extreme variability in the value of the dollar over the past several years, what is apparent from the above is that domestic policies, whether fiscal or monetary, appear to bear an important responsibility for the changes that have occurred. As a consequence, our problem may have less to do with the form of the international exchange rate system than with whatever set of domestic policies are driving the economy and the expectations about its future. Whether exchange rates are fixed or floating, a monetary policy of substantial ease or restraint will still create problems in the international accounts, as the history of the last twenty-five years amply demonstrates.

In recognition of this linkage, many of the proposals to reform the international monetary system also entail a fundamental reform of the domestic monetary system and changes in the operating procedures of the Federal Reserve Board. Covering a wide spectrum of opinion, these proposals range from the modest requirement that the Fed adhere to a price/quantity rule to proposals that would involve a return to a full-blown gold standard. In subsequent issues of the OUTLOOK, these and other proposals will be discussed in greater depth.

MANUFACTURING TRADE AND PRODUCTIVITY

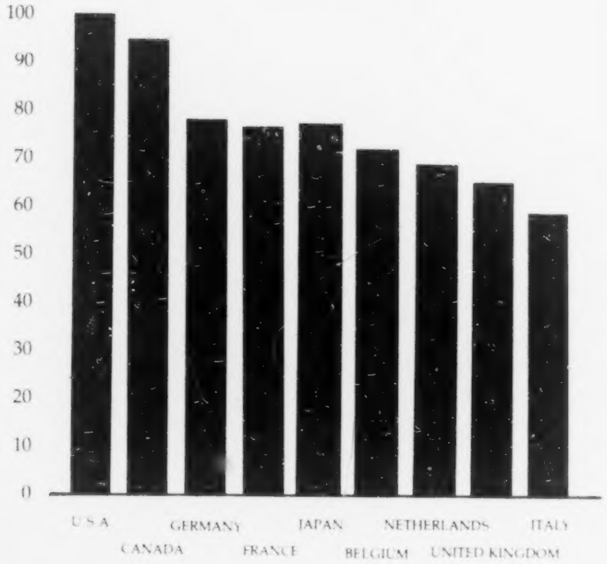
by
Martin Lefkowitz

Is America losing the productivity battle? Do Americans produce less than their counterparts in other countries? Most people would answer these questions in the affirmative, but the correct answer requires some equivocation. Americans would be surprised to learn that, as a group, we are the most productive workers in the world. Labor productivity, that is, the amount of output produced per employed person, is higher in the U.S. than in any other industrialized nation. But for some key industries, we have clearly fallen behind, and overall, other nations are gaining on us despite our recent improvements.

The reason for the prevailing misconception is twofold. First, many analysts compare relative growth rates in productivity rather than the levels of total output per worker. Secondly, international comparisons usually concentrate on the manufacturing sector which is a shrinking segment of most advanced economies. As Chart 1 illustrates, using a more comprehensive measure – GDP per employed worker – the U.S. scores the highest. Manufacturing employs only one-fifth of America's workers and is, therefore, not necessarily representative of economy-wide performance.

Although the U.S. remains in the lead, we cannot afford to be complacent because our international com-

CHART 1
GROSS DOMESTIC PRODUCT PER EMPLOYED PERSON
(percent)



petitors are narrowing the gap. This trend becomes painfully apparent when we look at changes in productivity over time.

Using the broadest measure of productivity, gross domestic product (GDP) per employed person, U.S. productivity rose at a 2.0 percent annual rate between 1950 and 1960 and at a 2.1 percent annual rate between 1960 and 1970. During the 1970s, however, growth in output per employed person slowed markedly, rising by only 1.4 percent. The slowdown in output per employed worker is even more dramatic when using 1973, the year of the first major oil price increase, as the break-point in the series. From 1960 to 1973, productivity increased at a 2.2 percent annual rate. However, between 1973 and 1984, it rose by only 0.6 percent. The impact of this slowdown was profound and can best be illustrated by the fact that 1984 GNP would have been 19.2 percent higher if productivity had continued to grow at the rate which prevailed prior to 1973.

At the same time that American productivity growth was slowing down, Japan was going through the same experience, but the decline in U.S. productivity growth was much faster than that which occurred in Japan, leading to a rapid narrowing of the gap between the two countries. Output per worker in Japan increased at three times the U.S rate in the 1950s, over four times faster in the 1960s, and five times the U.S. rate in the 1970s. As a consequence, U.S. workers who produced six times more than their Japanese counterpart in 1950, were ahead by only a third in 1980. Since then, U.S. output per employed worker has increased at a rate of 1.4 percent per year compared to an increase of 3.0 percent per year in Japan. At the current rate of change, by the year 2000, output per employed worker in the U.S. will exceed that of Japan by only about eight percent.

Why Are We Losing Ground?

What has caused these differences in productivity growth rates? One answer can be found in the amount of capital investment which has taken place in the U.S. compared to that in other industrialized countries. With the exception of the United Kingdom, the U.S. has consistently invested a lower percentage of its GNP than other major countries. Japan, in contrast, has invested more than any other nation. In the U.S., the ratio of gross fixed capital formation to GNP has ranged between 16 and 20 percent while in Japan the ratio has fluctuated between 28 and 35 percent. It is this capital formation gap which explains much of the difference in productivity performance between our two countries. Put another way, while the Japanese are currently investing about $8,000 per worker per year, Americans are investing only about $6,000 per worker.

While there are many reasons to explain the differences in investment performance, a chief one is the relative difference in the cost of capital between the U.S. and Japan. Because of a more favorable tax system, the cost of capital in Japan is estimated to be 16 percent lower than it is in the U.S. A recent study by the Institute of Political Economy estimates that if we adopted the Japanese tax system, U.S. investment would be 24 percent higher.

Further, increases in manufacturing productivity are also influenced by factors such as the mix of industries in each economy. For instance, industrial shifts from low value added industries to high value added industries result in rising productivity – a shift of workers from the textile industry to the chemical industry would automatically increase productivity in manufacturing. Measurements of labor productivity may therefore, be misleading in as much as they do not take into account these inter-industry shifts (see "The Productivity Challenge", ECONOMIC OUTLOOK, April 1985). Some of the gains in European productivity may be the result of the rapid shrinkage of low productivity industries, rather than any real advances in the manufacturing sector.

How Does America Measure Up in Manufacturing?

The deterioration in America's ability to compete in the international market for manufactured products is the most significant explanatory factor in the explosion of the trade deficit in the 1980s. The merchandise trade deficit more than tripled from $42.7 billion in 1982 to $123 billion in 1984 and could reach as high as $150 billion this year. In 1980, the U.S. had a trade surplus in manufactured goods of $18.8 billion; by 1984, it had turned into a $78 billion deficit. As Table 1 shows, this drastic widening of

TABLE 1

EXPORTS AND IMPORTS OF MANUFACTURED GOODS
(1980–1984)
($ Billions)

Year	Exports	Imports	Balance
1980	$144.0	$125.1	+18.8
1981	154.3	142.5	+11.8
1982	139.7	144.0	-4.3
1983	132.4	163.4	-31.0
1984	143.1	221.5	-78.4

Source: U.S. Department of Commerce

the deficit is the result of increased import penetration of manufactured goods rather than declining exports.

Although the rate of increase in U.S. manufacturing productivity has improved markedly since the end of the recession, it is still below that of our competitors (see Table 2). However, the gains in productivity in those countries are the result of modest increases in output accompanied by either small increases or actual decreases in employment and hours. Whereas the increase in U.S. productivity was accomplished by a surge in employment of more than eight million new jobs since the recovery began, including 1.3 million manufacturing jobs, European employment has actually declined.

TABLE 2

OUTPUT PER HOUR IN MAJOR INDUSTRIALIZED COUNTRIES
(growth rate)

Country	1973–1984	1983	1984
United States	2.0%	4.3%	3.5%
Canada	1.7	6.4	4.0
Japan	7.3	5.1	9.5
France	4.6	4.3	5.0
Germany	3.3	4.7	4.7
Italy	3.7	2.4	6.3
United Kingdom	2.3	6.7	3.9

Source: U.S. Department of Labor

Although the U.S still holds a commanding lead over Japan in total productivity per worker (see Chart 1), the gap narrows when the comparison is limited to the manufacturing sector. A study prepared by Elliot Grossman of the American Productivity Center indicates that much of the improvement in Japanese productivity has occurred in the manufacturing sector. From 1970 to 1981, the level of Japanese labor productivity in manufacturing industries rose from 49 percent to 82 percent of the American level. More significantly, output per hour in certain industries far exceeded the level of output in the U.S. As Table 3 demonstrates Japanese workers are now much more productive than their American counterparts in the manufacture of chemicals, primary metals, electrical machinery, and transportation equipment, including automobiles.

TABLE 3

COMPARISON OF ACTUAL LABOR PRODUCTIVITY LEVELS BETWEEN THE U.S. AND JAPAN—1981
(1975 U.S. Dollar Output Per Hour)

	Japan	U.S.	Japanese Output as a % of U .S.
Total Manufacturing	$ 8.68	$10.54	82.3%
Food and Tobacco	6.92	13.74	50.4
Textiles	3.20	7.64	41.9
Pulp and Paper	9.60	11.47	83.6
Chemicals	19.87	15.03	132.2
Primary Metals	19.48	13.29	146.5
Fabricated Metals	5.05	10.35	48.8
Nonelectrical Machinery	9.36	11.10	84.3
Electrical Machinery	15.85	11.32	140.0
Transportation Equipment	11.38	10.26	110.9
Other Manufacturing	5.45	8.33	54.0

Source: "Productivity and International Competition: United States and Japanese Industry", William Grossman.

Are We Losing Ground in the Manufacturing Sector?

The fact is that while much has been said of declining employment in the U.S. manufacturing sector, manufacturing employment has been declining in most developed countries for the last decade.

Table 4 indicates that, during that last ten years, U.S. productivity growth has not kept pace with other major industrial nations. The only major trading partner that we have outperformed is Canada. What is most surprising about the data is that all of the countries listed experienced declines in manufacturing employment between 1974 and 1984. But, while much has been said about the decline in U.S.manufacturing employment, the fact is that, with the exception of Japan, the U.S. experienced the smallest decline in manufacturing employment. As has been noted, the European nations have suffered substantial declines in manufacturing employment, ranging from 11 percent in Italy to 29 percent in the U.K., compared to only 1.9 percent in the U.S.

TABLE 4

COMPARISON OF MANUFACTURING PAY AND EMPLOYMENT FOR MAJOR INDUSTRIALIZED COUNTRIES

Country	Pay Per Hour ($U.S.)	Percent Change in Manufacturing Employment (1974 to 1984)	Change in Annual Output per Hour (1973 to 1984)
United States	$12.82	-1.9%	2.0%
Canada	11.51	-2.5	1.7
Japan	6.42	-0.4	7.3
France	7.23	-17.9	4.6
Germany	9.57	-16.4	3.3
Italy	7.43	-11.1	3.7
United Kingdom	5.95	-29.4	2.3

Source: U.S. Department of Labor

While international trade accounts for only about 22 percent of all goods produced in the U.S., exports account for nearly 38 percent of all goods produced in Japan. Moreover, production in certain Japanese industries is geared towards exports rather than the domestic market. For example, the American auto industry exports 7.6 percent of its total production and the U.S. imports eight times as many cars as it exports. By contrast the Japanese export 56 percent of their automobile production and import only one percent of what they export (see Table 5).

TABLE 5
EXPORTS AS A PERCENT OF JAPAN'S PRODUCTION
(1984)

Product	Percent of Output Exported
35 MM Cameras	82%
Watches	84
Motorcycles	46
Video Recorders	81
Color TVs	61
Microwave Ovens	78
Electronic Calculators	79
Automobiles	56
Iron and Steel	29

Source: Japanese Ministry of Finance

A World Bank study of the composition of Japanese international trade indicates that Japanese exports are concentrated in high-wage, high-skill, capital-intensive industries, while imports are largely unskilled labor-intensive products. This marks a reversal from earlier times when the Japanese were exporting labor intensive, low capital input goods.

The combination of relatively lower rates of growth in U.S. labor productivity and the strong dollar have significantly reduced the international competitiveness of U.S. products. Yet, the data reveals that America remains the leading exporter in the free world, U.S. exports comprise about one-eighth of total free world exports. In 1984, the U.S. exported one-fourth more than Japan and twice as much as the U.K. and Italy.

The concept of comparative productivity has to be looked at in its totality. Labor productivity in the U.S. is still substantially ahead of all other major nations. The problems that we are currently experiencing are industry specific, and are concentrated in those industries where U.S. technology has fallen behind, as other nations have either adopted our methods or have enjoyed adopted technological advances larger than our own, as is the case with the steel and auto industries. To confront this challenge, the policy choices available to the U.S. are three: (1) increasing spending for research and development geared toward matching or exceeding the technological advances of other nations; (2) improving investment incentives to raise U.S. capital formation; or (3) adopting protectionist measures.

The first two alternatives are clearly the best options. Increased R&D spending will not only improve the competitive position of American industries; it also plays a significant role in increasing U.S. economic efficiency and productivity. Similarly, a low level of capital formation in the United States has been shown to be responsible for much of the lower rates of growth in U.S. productivity compared to Japan. Both private R&D spending and nonresidential investment, particularly investment in productivity-enhancing producers' durable equipment, can be significantly improved through fiscal policy measures that improve investment incentives. Clearly, as a previous article in this issue of the OUTLOOK shows, the tax reform plan now being considered is a step in the wrong direction as it would significantly reduce investment and thus, worsen the prospects for further improvements in U.S. productivity.

Although protectionist measures have been used to grant targeted industries a breathing spell in which to "catch-up "to their international competitors, the costs to U.S. consumers and the economy as a whole have been tremendous. For instance, the voluntary marketing arrangement used to "save" the U.S. automobile industry resulted in sharp increases in the price of both domestic and imported cars. Last year alone, existing protectionist laws in autos, footwear, sugar, apparel and textile, are estimated to have cost U.S. consumers $26.9 billion.

Conclusion

The performance of U.S. productivity and exports is intimately linked. Improvements in labor productivity translate into improved international competitiveness. However, the emphasis on labor productivity and manufacturing trade ignores a sector of the American economy that has been a significant source of strength, i.e., services. Measures of labor productivity only take into account one factor input and, as a result, do not measure economy-wide efficiency. The increase in service sector productivity has resulted from the more efficient use of capital rather than labor inputs. Moreover, the U.S. has experienced significant gains in international trade in services. Over the years, the U.S. has sold services such as oil management, hospital management, television programs and computer programs to the world. While the U.S. merchandise trade account suffered a $106 billion deficit last year, trade in services enjoyed a $42 billion surplus. Thus, many feel that it is in the services area that the U.S. holds its comparative advantage and should seek to open more trade in this sector.

TRENDS IN COMMERCE
NOTES ON TABLE II
DECEMBER, 1985

by
Martin Lefkowitz

Gross National Product (GNP)—The Department of Commerce's revised estimate of the nation's economic performance as measured by Gross National Product—the value of the output of goods and services—shows that the inflation-adjusted growth rate for the third quarter was 4.3 percent. This represents a $17.6 billion improvement over the second quarter. Personal consumption expenditures, residential investment and government purchases accounted for most of the third quarter increase, while net exports and a reduced rate of inventory accumulation were the major negative factors. The only major sector that declined in the third quarter was nonresidential fixed investment. Real final sales rose by $23.4 billion, or 5.7 percent.

The Services Sector—Employment in service sector establishments rose by 0.2 percent in November and is now 3.9 percent above its year-ago level. This compares with a 0.5 percent increase in employment in the goods producing sector over the last year. Over 90 percent of the job growth in the economy during the past year has been in services industries.

Consumer purchases of services which comprise 51 percent of total personal consumption expenditures, rose by 0.6 percent in October. Major domestic airlines reported that revenue passenger miles flown, that is, the number of passengers multiplied by the miles flown by each passenger, reached 24.5 billion in October, an increase of 5.2 percent from last year. For the first ten months of 1985, major U.S. carriers reported an 11 percent increase in revenue passenger miles flown compared to the same period in 1984.

Money Supply—The nation's money supply—as measured by M-1, currency in circulation plus demand deposits—decreased by 0.1 percent from September to October, compared to a 0.9 percent increase from August to September. The money supply has been growing at a 13.8 percent seasonally adjusted annual rate in the latest three month period.

Employment—The civilian unemployment rate fell to 7.0 percent in November from 7.1 percent September and October. The stickiness in the unemployment rate over the past year should not be interpreted as a sign of economic weakness but is indicative of significant and rapid growth in the labor force. Civilian employment—as measured by the monthly survey of households—increased by 60,000 persons (seasonally adjusted), following an increase of 323,000 from September to October. The number of nonagricultural payroll jobs—as measured by the monthly survey of business establishments—increased by 182,000 in November, reflecting an across the board gain, including an increase in manufacturing jobs.

Prices—The Consumer Price Index for all urban consumers (CPI-U) increased 0.3 percent in October following five consecutive months of 0.2 percent increases. The October increase was due to higher auto prices, increases in auto finance rates as dealers incentive finance plans were discontinued, and a $2.00 per gallon increase in liquor taxes. Consumer prices in October were 3.2 percent higher than their year-ago level.

Following two months of decline, finished goods wholesale prices jumped 0.8 percent in November, following a 0.9 percent increase in October. Food and automobile prices were the major factors pushing up wholesale prices for the month. From November 1984 to November 1985, the finished goods index has increased by 1.5 percent with virtually all the increase occurring in the last month.

Crude goods prices increased 2.9 percent in November, following a 3.1 percent increase in October. The November increase was largely due to a considerable rise in foodstuff prices. Crude food and feedstuff prices increased 5.8 percent in November, after advancing 6.3 percent in the preceding month. Following a drop of 0.3 percent in October, the crude energy materials index fell 0.1 percent. The index for crude nonfood materials other than energy edged down 0.2 percent, after rising 0.5 percent in October.

Housing Starts—Privately owned housing units were started at a seasonally adjusted annual rate of 1,547,000 in November, a 12 percent drop from the October level. Building permits, an indicator of future activity in the home building industry, decreased 2 percent in November but were still 2 percent above year-ago levels. Both housing starts and building permits have been fluctuating erratically in recent months and appear not to show a particular trend at this time. But most observers would be inclined to predict an increase in starts due to the continued declines in mortgage interest rates.

Industrial Production—Industrial production increased by 0.4 percent in November, following two months of decline.

The capacity utilization rate in manufacturing increased 0.2 percentage points in November to 80 percent. Motor vehicles and parts showed a significant increase in operating rates. Manufacturing capacity rose 0.7 percent in the third quarter of 1985, a 3.0 percent increase from a year ago.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Sep/85	239.4	239.2	237.3	0.1	0.9
Gross National Product ($B)	III/85	3,915.9	3,853.1	3,694.6	1.6	6.0
Gross National Product (72$B)	III/85	1,688.9	1,671.3	1,645.2	1.1	2.7
Money Supply (M1) ($B)	Oct/85	611.1	611.9	548.3	-0.1	11.5
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Oct/85	2,544.2	2,567.6	2,378.1	-0.9	7.0
Personal Consumption Expenditures (72$B)	Sep/85	1,128.9	1,116.6	1,072.2	1.1	5.3
Disposable Personal Income ($B)	Oct/85	2,725.4	2,715.7	2,633.3	0.4	3.5
Disposable Personal Income (72$)	Sep/85	1,194.0	1,192.3	1,180.7	0.1	1.1
Personal Savings Rate (%)	Oct/85	2.9	1.8	6.5	1.1[b]	-3.6[b]
Civilian Employment (millions)	Nov/85	107.9	107.9	105.9	0.0	
Civilian Unemployment Rate (%)	Nov/85	7.0	7.1	7.1	-0.1[b]	-0.1[b]
Average Hourly Earnings	Nov/85	$8.67	$8.64	$8.42	0.3	3.0
Consumer Price Index (All Urban, 67 = 100) [a]	Oct/85	325.5	324.5	315.4	0.3	3.2
Purchasing Power of the Dollar (67 = $1.00) [a]	Oct/85	0.308	0.309	0.318	-0.308	-3.081
Prime Interest Rate (%) December 5, 1985		9.5	9.5	11.25	0.0[b]	-1.75[b]
Retail Sales ($)	Nov/85	115.9	114.6	110.3	1.2	5.1
SERVICES SECTOR						
Employment in Services (Millions)	Nov/85	73.7	73.5	70.9	0.3	3.9
Consumer Purchases of Service ($B)	Oct/85	1,297.1	1,288.9	1,197.9	0.6	8.3
Consumer Purchases of Service (72$B)	Sep/85	511.5	511.6	495.3	0.0	3.3
Revenue Passenger Mileage Flown Major Airlines (Billions) [a]	Oct/85	24.5	23.3	23.3	5.2	5.2
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B) [a]						
Before Tax [a]	III/85	232.8	221.0	224.8	5.3	3.6
After Tax [a]	III/85	144.7	137.4	141.7	5.3	2.1
Industrial Production (67 = 100)	Nov/85	125.1	124.6	123.4	0.4	1.4
Capacity Utilization Rate (Mfg.) (%)	Nov/85	80.0	79.8	81.2	0.2[b]	-1.2[b]
New Housing Starts (thou. units)	Nov/85	1,547.0	1,761.0	1,600.0	-12.2	-3.3
Net Business Formation (67 = 100) [a]	Oct/85	115.0	117.1	117.7	-1.8	-2.3
New Business Incorporations (Thousands)	Jun/85	55.3	56.1	54.7	-1.4	1.1
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	III/85	164.8	164.1	159.5	0.4	3.3
Unit Nonlabor Costs (nonfarm) (77 = 100)	III/85	158.3	158.8	154.5	-0.3	2.5
Producer Price Indices (67 = 100)						
Crude Materials	Nov/85	305.6	298.0	323.7	2.6	-5.6
Intermediate Goods	Nov/85	318.1	317.8	320.5	0.1	-0.7
Finished Goods	Nov/85	296.7	294.8	292.3	0.6	1.5
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100)	Oct/85	596.9	557.3	568.5	7.1	5.0
Federal Government Debt Outstanding ($B) [a]	Jun/85	1,779.0	1,758.3	1,517.2	1.2	17.3
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	III/85	346.8	347.7	368.6	-0.3	-5.9
Imports of Goods & Services ($B)	III/85	450.8	441.6	449.3	2.1	-1.9
Balance on Goods & Services ($B)	III/85	-104.0	-93.9	-90.7	10.8	14.7
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	Oct/85	171.1	170.6	164.2	0.3	4.2

NOTES: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted

[b] Percentage point difference

Productivity–Nonfarm business productivity increased at a 2.1 percent annual rate in the third quarter. Nonfarm business output grew at a 3.9 percent annual rate as a result of a 1.8 percent increase in the number of hours worked combined with the increase in productivity. Manufacturing productivity in the third quarter grew at a 3.7 percent annual rate while output rose at a 3.3 percent annual rate, reducing the number of hours worked by 0.3 percent

Interest Rates–At 9.5 percent, the prime interest rate is 1.75 percentage points below the rate at this time last year. Three-month Treasury bill rates in the first week of December were at 7.47 percent, about the same level as in early November. Thirty year Treasury stood at 9.9 percent compared to 10.12 percent during the first week of November.

Business Failures and Formations–Dun and Bradstreet's Index of Business Failures indicates that business failures in October increased by 10 percent as compared to September. Business failures in the first ten months of 1985 increased by 8.6 percent from their year-ago levels, and total business closings were up about 13.8 percent.

Dun and Bradstreet reported that 334,831 new business corporations were formed in the first six months of 1985, an increase of 2.8 percent from last year. Seven of the nine census regions reported an increase in new business corporations formed in the first six months of 1985 compared to 1984. The New England and South Atlantic regions reported the largest gains in incorporations, while the Pacific and West North Central regions reported declines in the first half of the year. There were 1.9 percent fewer new business corporations formed in June of 1985 as compared to June 1984, with 15 states actually reporting decreases of over 10 percent while only 20 states reported increases.

Federal Spending–The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, increased by 5.0 percent in October compared to its year-ago level. Federal receipts, during the same period, increased by 10.8 percent due mainly to a 16 percent increase in personal and corporate income, and social insurance taxes. The data on tax receipts indicates that federal tax revenues continue to increase at a faster rate than increases in income. The larger increase in revenues than expenditures for the first month of fiscal year 1986 resulted in a $27.2 billion deficit for the first month of the year compared to $28.8 billion in FY 1985.

Personal Savings–In October, personal savings bounced back to 2.9 percent of disposable income after reaching an all time low of 1.8 percent in September. Personal consumption spending declined 0.9 percent in October, following a 1.2 percent increase in September. While consumer savings have only been increasing by an average of $137 billion per year, about 5.5 percent of income, the net value of consumers' financial assets has been increasing by more than $300 billion per year as a result of the stock market rally and increased pension fund assets. The improved financial position resulting from the appreciation of these financial assets may be helping to keep consumer spending at current high levels.

Retail Sales–Retail sales increased 1.2 percent in November following a decline of 3.3 percent in October, and a 2.1 percent increase in September. November retail sales were 5.1 percent higher than in November 1984. During the September through November period, total retail sales showed a 1.4 percent increase over the prior three-month period. Durable goods sales increased 5.8 percent from November 1984, and automotive sales increased 4.7 percent from last year's level. Nondurable goods in November increased 1.3 percent from last month and 4.7 percent over its year-ago level.

Trade Deficit–The trade deficit continued to increase in the third quarter following very large increases in the first two quarters of 1985. On a goods and services basis, the trade deficit rose to $104 billion in the third quarter, following an increase to $94 billion in the second quarter. The rise in the trade deficit can be attributed to an increase in imports, while exports fell slightly. On a balance of payments basis, the seasonally adjusted merchandise trade deficit hit a record $33.4 billion in the third quarter after. On a monthly basis, the merchandise trade deficit in October plunged to $11.5 billion from a record $15.5 billion in September. The decline in the merchandise trade deficit was the result of a lower level of manufactured imports as exports continued to stagnate. The Department of Commerce reported a $500 million drop in steel imports as a major contributing factor to the decline in the trade deficit for the month.

What's Ahead–The composite index of leading indicators, designed to predict future movements in aggregate economic activity, increased 0.3 percent in October, with six of the 11 available indicators up, while four were down, and one was unchanged. This follows a revised 0.4 percent increase for September that was previously reported as a 0.1 percent gain. October is the fifth consecutive month in which the leading indicators have increased.

SPENDING BEYOND OUR MEANS

Private and public debt in the United States adds up to a staggering $4 trillion. From this, one could easily get the impression that our society has a propensity to spend far beyond its means. Like a group of "drunken sailors" we simply lack the discipline to control our spending habits. A closer look at the statistics reveals that the situation is not nearly as bad as it may appear. While our public spending habits most definitely require discipline, our consumer spending habits are essentially sound.

The total debt of U.S. households has increased at a rapid pace during the current upturn. With household debt now exceeding $2 trillion, the increase has rekindled concerns that households have become financially overextended. However, the data shows that the ratios of household liabilities to total assets and to total financial assets have remained fairly stable, implying that the net worth of households has risen. Further, the increase in household borrowing in the last two years has not been accompanied by a significant increase in illiquidity. Except for the short recovery period between the 1980 and 1982 recessions, growth in consumer debt has accelerated at the start of each business expansion and slowed around the start of each recession. Consumer borrowing for houses and consumer durables, therefore, is likely to rise during economic expansions when employment and income prospects are bright and fall during recessions.

While household debt trends are consistent with responsible spending habits, the enormous growth of public debt spells fiscal irresponsibility. Unlike households, the federal government has been taking an ever increasing share of our nation's output. It took over 150 years for the federal government to claim 10 percent of our gross national product (GNP) which it did in 1940. Since that time, federal expenditures have risen to almost 25 percent of GNP. This is the primary reason why we confront $200 billion deficits.

Over the last century, U.S. public spending has been rising at an annual rate almost 2 to 3 times faster than GNP. While this trend is noteworthy in itself, its ramifications can be shocking. According to some estimates, if we extrapolate the historical trend of federal expenditures into the future, federal expenditures as a percent of GNP will approach 40 percent by the year 2036. By this timetable, the actual percentage of federal expenditures for 1985 would be in the neighborhood of 24 percent, which means that the actual FY 1985 share of 24.5 percent is right on schedule!

Adding in the spending of state and local governments, total U.S. public spending is approximately 38 percent of GNP. While this percentage is formidable, one only has to look at Europe to see how far the trend towards big government can go. Public spending has now grown to 51 percent of Europe's GNP, with several governments now spending in excess of 60 percent of GNP. The results have been devastating as European economies now breed economic stagnation. With a smaller public sector in the 1960s (33 percent of GNP), real economic growth in Europe averaged a brisk 4.4 percent. However, a rising public sector has caused average real economic growth to fall to 2.5 percent for the 1975-79 period. In the 1980-84 period, real economic growth has plummeted to less than 1 percent.

Hopefully, the European experience will provide a valuable lesson for policy makers in the U.S. However, if recent experience is any guide, it looks as though we may be traveling down the same path. In spite of Congress' harangue about deficit spending, the evidence demonstrates otherwise. Federal spending has more than tripled from $267 billion in 1974 to $950 billion in 1985. Inflation adjusted spending increased at a 17.5 percent rate over the 4 years of the Carter administration and, surprisingly at the same rate during the first Reagan term. In fact, in the past 5 years, Congress has surpassed its own budget resolutions by an average of $28 billion a year. Nor is lack of tax revenues a problem, tax revenues have increased by 22 percent over the past two years, demonstrating that our deficit problem is not too few tax dollars but too much spending.

In summary, when a household makes a decision to borrow and spend, it is fully responsible for its actions. If debts pile up, households are constrained to take actions that lead to fiscal responsibility. As consumer debt rises, the consumer's ability to pay off those debts typically rises also. This is not the case in the public sector. Here, our elected representatives can gain votes by promoting extravagant and inefficient spending programs that benefit their parochial constituencies by passing the "buck" to the general public. Consequently, the general taxpayer is saddled with higher taxes and future generations bear a greater public debt burden.

PER CAPITA TAXES UP NEARLY TEN PERCENT IN 1984

The Census Bureau reported that per capita federal, state, and local government taxes in fiscal year 1984 rose 9.4 percent over 1983. Taxes collected by the three levels of government totaled $3,112 per person, showing an increase of $267 over the previous period. The federal government share of total tax revenues was 56 percent, the state government share was 27 percent, and the local government share, 17 percent.

The states which showed expenditures by state and local governments accounting for more than one-half of government spending below the federal level in 1984 were: California ($74.1 billion), New York ($65.0 billion), Texas ($35.3 billion), Illinois ($27.2 billion), Pennsylvania ($26.6 billion), Ohio ($25.4 billion), Michigan ($25.4 billion), and Florida ($23.4 billion).

ECONOMIC
OUTLOOK

Chamber of Commerce of the United States
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A UNIQUE OPPORTUNITY

by
Richard L. Lesher and Richard W. Rahn*

The recent convergence of favorable political and economic events leads us to believe that the President, the Congress and the business community have been offered a rare opportunity to set the nation on a course of long-lasting economic prosperity. An optimistic statement? No doubt about it, but we are convinced that the facts support it and that economic growth rates have the potential to approach those of 1984.

What are these favorable events? First, is the collapse of OPEC and the precipitous decline in world oil prices. If oil prices were to fall to $10 a barrel, which is certainly possible, real GNP could be at least one percentage point higher this year and next. This is not an altogether unrealistic assumption given how quickly oil prices fell below $16 and how much further they could fall before bumping against the lifting costs in the world's major oil fields.

Our simulations of such an oil price decline on an econometric model of the U.S. economy suggest that the impact will be substantial. A $10 per barrel price decline would increase real GNP growth by 1.2 percentage points this year, raise civilian employment by a cumulative 1.4 million jobs in 1986-87, reduce inflation by 1.2 percentage points in 1986 and 0.3 percentage points in 1987, and reduce short-term interest rates by 30 basis points in 1986 and 20 basis points in 1987.

The combination of stronger income growth and lower interest rates would also serve to reduce the budget deficit by a cumulative $20 billion over two years. If we factor this into the Administration's forecast of four percent real growth per year, expected growth rates could rise to the 4.8 percent to 5.2 percent range this year and next.

The second major event, this one political, is the enactment of the Gramm-Rudman-Hollings Act, easily one of the most radical and potentially most effective spending reduction proposals ever enacted by Congress. It is easy to criticize the Act, and most pundits have had a field day doing so, spewing forth an abundance of vitriolic ink that more than matches the red ink produced by Congress through their more "thoughtful" deficit reduction efforts. If found to be constitutional after full judicial review, this law could have a profound impact on spending growth.

In thinking about the many comments on Gramm-Rudman-Hollings, one is reminded of what Winston Churchill said about democracy—that it is the worst form of government except for all the others. We could easily extend this to Gramm-Rudman-Hollings. Yes it's crude, inequitable and thoughtless, but unlike all the alternatives, it works! We've already knocked $12 billion off this year's budget and much more will be headed for the chopping block in future years. For the first time in memory, government spending will be firmly limited, choices will be made and resources will be shifted to the more productive private sector. The debureaucraticization of America is at hand as government is forced to get by with less and the long-promised efficiencies are forced on the reluctant Leviathan.

With the 1987 baseline deficit projected to come in at $178 billion, the $34 billion of required spending reductions are well within the feasible range and give both Congress and the President an opportunity to avoid the painful process of sequestration. Moreover, with the extra economic stimulus provided by the oil price collapse, the required spending reduction targets could be even less, thereby making Gramm-Rudman-Hollings all the more workable.

IN THIS ISSUE

A Unique Opportunity .... p. 1
Likelihood of Above Average Strength in the 1986 Economy Increases .... p. 3
Forecast Table .... p. 4
Privatizing Federal Programs .... p. 5
Are Credit Card Interest Rates Too High? .... p. 10
Trends in Commerce .... p. 15

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The only remaining obstacle to fulfilling the promise that these two events offer is the "successful" resolution of the tax reform debate, with emphasis on the word "successful," by which we mean a tax reform package that enhances the economy's potential through substantially lower marginal tax rates, strong incentives for capital formation, and a date certain for enactment, preferably January 1, 1987.

Regrettably, there are many obstacles blocking the way to this eminently sensible goal.

As we reported in last month's issue of ECONOMIC OUTLOOK, the tax reform package, as it is currently structured, will have a significantly negative impact on business investment. An abundance of studies, including our own, have demonstrated this. Moreover, we believe that the debate over tax reform is already having a negative impact on the economy. Congress and the Administration will not decide on, and make public, a definite effective date for tax reform. The lack of commitment from our nation's leaders has propelled the business community into a virtual twilight zone of uncertainty – a land where business investment in plant and equipment hangs in suspended animation – delayed or even cancelled due to uncertainty about the impending tax reform and the date when it will ~~become~~ effective.

If Congress and the Administration cannot get their act together, the lack of an effective date could greatly reduce economic growth this year as capital investment stagnates or even declines, leading to a chain reaction of deterioration throughout the economy. The delayed investment, if it continues, will have a disastrous effect on economic growth for 1986. Anecdotal evidence, much of it reaching us from U.S. Chamber members, indicates that many businessmen have already delayed investment plans because of uncertainty about the future tax code. If such uncertainty is happening on an economy-wide scale – and we have a strong feeling that it is – economic growth for 1986 could be markedly reduced. Already, three separate surveys of business capital spending plans project a decline for 1986.

The House tax reform bill, passed last December, contains various effective dates depending on the provision. Some effective dates (such as for use of the investment tax credit) are retroactive to as far back as September 26, 1985. This means that those who were not aware of the early date, or were not able to speed up an already planned investment in order to take advantage of the ITC will find themselves with a higher tax bill and a less profitable investment. By picking a uniform, effective, future date for tax reform, some revenues would be lost, but such a loss would be partially offset by higher revenues from a stronger economy. Such revenue losses would have to be made up elsewhere in the bill as long as Congress binds itself to a goal of static revenue neutrality.

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Counterproductive tax reform is not the only tax-related risk confronting us. The imposition of any form of major tax increase, including the levying of an oil import fee to cut the deficit, would squander the unique opportunity that the collapse of OPEC and the Gramm-Rudman-Hollings Act offer the U.S.

While we are optimistic about the implications of the Gramm-Rudman-Hollings Act, we have been around Washington long enough to know that this town possesses the potential for turning a useful tool into a lethal weapon.

On the pessimistic end of the process, we have two potential outcomes:

(1) First, the courts could find the amendment unconstitutional. If this occurs we revert to the Act's back-up provisions which are not nearly as effective as the provision now being challenged in the courts.

(2) Second, major tax increases could be included as part of the package.

At the optimistic end are also two possible scenarios:

(1) First, Congress could bog down in budget negotiations, triggering a $30 billion spending sequester.

(2) Second, there is the possibility that Congress takes the amendment seriously and makes program reductions and avoids a tax increase.

Obviously, a healthy economy and an attractive political climate necessitate the occurrence of the last one, or some combination of the last two. Regrettably, the first round in the expedited judicial review process concluded that a key provision in the Act is unconstitutional. If this ruling stands on appeal, then obviously our optimism must be tempered. Nonetheless, we remain optimistic that Congress will see fit to make the Act's back-up provisions workable and achieve the required spending cuts.

With all of the potential good news emerging, it's perhaps understandable that we have managed, in our usual preoccupation with the gloomy side of life, to forget what has been happening in foreign exchange markets. Remember the exchange rate "crisis," the highly valued dollar and the exploding trade deficit? Well, that, too, is now well on the way to a satisfactory resolution. The yen, for example, which had been as high as 260 in 1985, is now trading at 190 to the dollar, a 27 percent decline in less than a year. This should go far toward rectifying the trade imbalances of the past few years, diminish protectionist pressures and begin erasing some of the red ink in our trade account.

More importantly, it should also contribute to stronger economic growth this year. In 1985, measured GNP was reduced because so much of the growth in sales during the year was satisfied by foreign products. With a lower valued dollar, this trend should be reversed and sales growth will go right to the bottom line, for both the economy and American business.

Although the high growth scenario could be achieved, the more likely outcome for 1986 is that real economic growth will rise by about 4 percent. Our assessment of the outcome of the key policy options that need resolution is as follows: (1) The tax reform bill that will finally be enacted will not be ideal but will be better than the Ways and Means proposal; (2) It is likely that a small tax increase will be enacted as part of the deficit reduction effort, but it will not be of a debilitating magnitude; (3) A big budget fight will ensue, with some substantive spending cuts, but they will not be as large as we need; and (4) The price of imported oil will, indeed, continue to decline but it will settle in the $13 to $15 per barrel range, and not fall to the $10 per barrel incorporated in our most optimistic scenario.

LIKELIHOOD OF ABOVE AVERAGE STRENGTH IN THE 1986 ECONOMY INCREASES

by
Graciela Testa-Ortiz

The preceding article outlined the possible economic scenarios now facing the United States. Again, the greatest risk surrounding this month's outlook is related to the outcome of the fiscal policy debate which has become doubly important this time around since it concerns not one, but two pieces of legislation – tax reform and deficit reduction. As the previous article mentions, the U.S. economy is poised at a crossroads. Given the correct policy choices, we could look forward to historically high rates of economic growth for the remainder of this decade. Alternatively, we could lose this opportunity to set the nation on a sustained high growth path. This month's forecast assumes that, this being Washington, fiscal policy does not fall in the optimum range, but that we are able to avoid a combination of all negative alternatives. The forecast assumes that Congress enacts deficit-reducing legislation, but falls short of the Gramm-Rudman-Hollings deficit goals. Uncertainty regarding tax reform looms so large that the forecast does not incorporate it. However, we have assumed that by midyear the doubts regarding the effective date of implementation of the bill will have been resolved.

End of year economic indicators, combined with the drops in oil prices, have renewed our confidence in a stronger economy for 1986 (see Trends in Commerce section in this issue). Most measures of economic health, from industrial production to personal income, to retail sales and housing starts posted unequivocal advances in December, closing out 1985 with a welcome show of strength. Moreover, external developments, in particular, the collapse of OPEC and the consequent slide in the price of imported oil presage higher growth and lower inflation, not only in the United States but abroad as well. As a result, we expect real GNP to rise by 3.9 percent this year and 4.7 percent in 1987.

As noted in previous issues of ECONOMIC OUTLOOK, we believe that concern regarding consumer indebtedness and the low personal savings rate is exaggerated. The latest data on outstanding consumer installment debt shows that during November, it experienced the smallest monthly advance in two years. Personal income rose a healthy 1.4 percent in December, with the bulk of the strength in the wages and salaries and farm income components. Moreover, the recent rallies in the stock and bond markets have increased consumer wealth. This, together with low rates of inflation and declining interest rates, has improved purchasing power and the outlook for consumer spending.

According to the University of Michigan survey, the consumer sentiment index rose to 94 in December and remains high relative to the early part of this decade. More importantly, respondents' optimism is based on an improved assessment of their financial situation, with a near record number reporting that they are now better off than they were a year ago. Consequently, we expect a strong showing in this sector during the current quarter, partly as a one-time adjustment to the sharp decline in purchases of durables that occurred in the last quarter of 1985. Thus, real consumer spending should continue to buoy economic activity during this year and next, rising by 3.7 percent in 1986 and 3.5 percent in 1987.

Housing starts, which behaved in quite an erratic manner last year despite continued declines in mortgage interest rates, rose by 17.5 percent in December to an annual rate of 1.84 million units. Given our assumption of continued improvements in housing affordability, as personal income and employment rise and mortgage interest rates continue to slide, we expect the residential investment sector to also contribute to this year's economic strength, rising by 11 percent compared to 1985's meager 1.9 percent increase. In such a climate, total new housing starts should reach the 1.9 million unit level with ease.

The investment sector, the mainstay of this recovery's strength, reflects the uncertainty surrounding the fiscal policy debate. Last year, business fixed investment rose by nearly ten percent, but that performance was marred

UNITED STATES ECONOMIC OUTLOOK 1986-1987
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates.)

	QUARTERS									YEARS			
	Actual			Forecast						Actual		Forecast	
	85:2	85:3	85:4	86:1	86:2	86:3	86:4	87:1	87:2	1984	1985	1986	1987
GROSS NATIONAL PRODUCT													
Real GNP	1.1	3.0	2.4	4.8	4.3	5.2	5.9	4.3	5.0	6.8	2.3	3.9	4.7
Consumption	2.6	4.6	-0.2	5.8	4.4	3.6	3.7	4.1	2.9	5.3	3.2	3.7	3.5
Residential Investment	7.1	8.5	8.6	12.3	16.5	10.5	6.4	4.7	2.1	12.2	1.9	11.0	4.7
Nonresidential Investment	12.5	2.4	10.3	3.3	5.9	7.0	9.6	6.4	10.2	19.8	9.7	6.4	8.3
Equipment	16.9	3.0	12.4	3.2	7.4	8.1	10.4	5.9	10.8	21.5	8.7	7.5	8.8
Structures	5.2	1.2	6.4	3.5	3.2	4.8	8.1	7.2	9.0	15.6	11.4	4.3	7.3
Exports	-10.9	-5.1	8.0	13.3	18.0	17.9	16.2	17.5	16.9	4.7	-2.9	9.8	16.7
Real Net Exports	-101.1	-119.8	-127.6	-128.6	-124.2	-116.1	-111.7	-103.3	-95.2		-105.1	-120.2	-91.6
Imports	18.2	12.8	13.0	10.6	9.3	6.6	8.7	6.8	7.1	27.0	2.1	10.8	7.3
Government Purchases	2.1	37.3	16.1	-16.7	-12.9	-3.6	9.0	1.1	0.1	3.5	9.8	-0.3	0.6
Final Sales	1.2	5.0	2.1	3.6	3.8	4.2	5.2	4.8	4.2	6.0	4.0	3.6	4.4
Change in Business Inventories (82$B)	15.1	-1.8	0.1	10.8	15.5	24.5	30.3	26.1	33.5	24.8	7.3	20.2	32.2
Industrial Production	2.0	3.1	1.4	7.5	5.9	8.8	10.6	6.5	8.6	10.6	2.5	5.5	7.8
New Car Sales (total, mill.)	10.9	12.4	10.3	11.3	11.8	11.7	11.7	12.2	12.7	10.4	11.1	11.6	12.1
New Domestic Car Sales (mill.)	8.2	9.4	7.0	8.6	8.7	8.7	8.7	9.2	9.2	8.0	8.2	8.7	9.1
New Housing Starts (total, mill.)	1.8	1.7	1.7	1.9	2.0	2.0	2.0	2.0	2.0	1.8	1.7	2.0	2.0
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	7.3	7.2	7.0	6.7	6.6	6.5	6.3	6.1	6.0	7.5	7.2	6.5	5.9
Compensation	4.1	3.7	3.7	4.7	3.1	3.2	3.3	4.3	3.7	4.2	3.9	3.8	3.7
Productivity	1.0	0.5	-1.9	2.7	1.7	2.7	2.9	1.8	2.4	2.7	0.0	1.4	2.1
Unit Labor Costs	3.1	3.2	5.6	2.0	1.4	0.5	0.4	2.5	1.3	1.4	3.8	1.0	2.4
Consumer Price Index	4.3	2.3	4.2	2.8	2.7	3.3	3.5	3.7	3.8	4.3	3.5	3.1	3.6
Implicit GNP Deflator	3.3	2.9	3.3	3.8	2.5	2.2	2.8	2.9	3.0	3.8	3.3	3.0	2.9
Prime Interest Rate (%)	10.2	9.5	9.5	9.2	9.0	8.8	8.4	7.9	7.4	12.0	9.9	8.8	7.3
3-mos. Treasury Bill Rate (%)	7.5	7.1	7.2	6.5	6.3	6.1	6.2	5.9	5.6	9.5	7.5	6.3	5.6
Corporate Bond Rate (%)	11.6	11.0	10.6	9.5	9.2	9.1	8.9	8.4	8.1	12.7	11.4	9.2	7.9
Real Personal Disposable Income	8.3	-4.6	2.5	6.0	2.6	2.0	2.9	3.6	2.0	6.7	1.5	3.4	2.2
Profits from Current Production ($B)[1]	201.0	222.0	224.0	250.0	247.0	258.0	275.0	284.0	298.0	195.9	213.0	258.0	301.0
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts										666.0	736	793	862
Unified Outlays										842.0	937	998	1027
Unified Deficit										-176.0	-201	-205	-165

[1] After-tax corporate profits with inventory valuation and capital consumption adjustments.

[2] Unified budget figures on a fiscal year basis.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's benchmark revision of the National Income and Product Accounts. The forecast assumes that Congress enacts deficit-reducing legislation, but falls short of the Gramm-Rudman deficit goals. Federal outlays are reduced by $12 billion in FY 1986 and $35 billion in FY 1987 with the bulk of the cuts stemming from defense purchases. The money supply, as measured by M1, rises by 8.3 percent in 1986 and 6.9 percent in 1987 (on a fourth-quarter over fourth-quarter basis). The price of a barrel of imported crude is assumed to average $13.50 in 1986 and $13 in 1987. The trade weighted exchange value of the dollar is anticipated to fall by 4.8 percent in 1986, but increase by 1.6 percent in 1987. The federal minimum wage is expected to remain at $3.35 an hour.

by quarterly swings in growth rates and was below 1984's increase. Business investment, and in particular, business investment in producers' durable equipment, is quite sensitive to businessmen's confidence in the nation's economy. As such, its lackluster performance is not surprising given the uncertainty engendered by the tax reform debate.

As we reported in the December issue of ECONOMIC OUTLOOK, an econometric study performed by Laurence H. Meyer and Associates shows that, as it is now structured, the tax reform package would have a significantly negative effect on business investment. Other studies have corroborated this view. In recent testimony before the Senate Finance Committee, Data Resources, Inc. also concluded that enactment of the tax reform package would reduce investment. These studies show what we are likely to experience if the tax reform package is enacted in its present form. Unfortunately, however, the debate itself is having a deleterious effect upon investment now.

As a result, surveys of investment intentions show real declines in capital spending for 1986. Our forecast is more optimistic in that we expect a resolution of the issue by midyear and that the effective date of the provisions will not be made retroactive. Therefore, nonresidential investment remains weak during the first half of the year, but rises during the second half, resulting in a year-over-year gain of only 6.4 percent.

The largest negative development during 1985 was, of course, the dismal performance of the foreign trade sector which, as anticipated, posted record deficits. However, there is a silver lining in the dark cloud of our massive trade deficit. The data for 1985 show that despite the fact that real net exports posted a $105 billion decline, real import growth slowed substantially, from 27 percent in 1984 to 2.1 percent in 1985. As a result, following a quadrupling in 1984, the trade deficit increased by only 27 percent in 1985. The outlook for the foreign sector is quite optimistic. Given the lags (from nine to twelve quarters), between changes in currency values and their impact on exports and imports, the decline in the value of the dollar since its peak in February should soon begin to have an impact on trade flows. As a result, we expect to see a significant turnaround in the performance of exports and imports during this year and next.

The major piece of fortuitous economic news is the disintegration of OPEC and the collapse of oil prices which has accompanied it. The drop in oil prices has increased the odds of a prolonged expansion by reducing inflationary pressures worldwide. As a consequence of falling inflationary expectations, interest rates should also ease. Assuming that our policymakers do not embark in a misguided effort to take advantage of the oil price decline to reduce the federal deficit by imposing an oil import fee, the economy-wide benefits will far outweigh the costs to the domestic oil industry. Globally, the decline in oil prices (which is dollar-denominated), at a time when the value of the dollar is also falling, means that oil importing countries other than the U.S. will be able to reap the full benefit of this price decline (which they had been unable to do in the past when the dollar was rising). In other words, we can expect much faster economic growth among our trading partners which will translate into increased demand for U.S. goods and services.

Our forecast assumes that the price of a barrel of imported oil falls to $13. This is not an altogether unrealistic assumption given the fact that it is extremely unlikely that the remnants of the cartel will be able to impose any type of discipline on themselves at this stage. Saudi Arabia, the only oil-exporting country which can afford to curtail production in order to prop up prices, has made it quite clear that they will no longer play that role, particularly when other cartel members remain uncooperative.

The gains to the nation's economy of such a price decline were noted in the previous article. Unfortunately, every time the price of oil falls attempts are made to impose an import fee on it in an attempt to "take advantage of" the price decline to close the federal deficit gap. However, the historical record shows that for every one dollar of import fee, real GNP is lowered by 0.2 percentage points, and inflation and the unemployment rate rise by nearly 0.1 percentage points.

PRIVATIZING FEDERAL PROGRAMS

by
Ronald D. Utt and William Orzechowski

With or without the Gramm-Rudman-Hollings Emergency Deficit Control Act, both Congress and the Administration will be confronted with exceptionally difficult decisions regarding the course of federal spending. Despite the ongoing commitment to deficit reduction, projected federal deficits will be in excess of $200 billion for the foreseeable future and intense efforts will be required just to keep the next year's deficit below the previous one. Gramm-Rudman-Hollings not only raises the stakes, but also provides enhanced powers to achieve the objective. In 1987 alone, it is estimated that over $50 billion in spending reductions will be needed to meet the stipulated deficit target of $144 billion. By fiscal year 1991, Gramm-Rudman requires that the federal budget be in balance. Meeting these objectives will require an unprecedented assault on federal spending and innovative solutions. It is our belief that an aggressive program of privatizing government programs could be an important part of the solution to this problem.

Background

Even with the enhanced powers provided by Gramm-Rudman, recent history demonstrates that the attainment of substantial deficit reduction targets through spending cuts will be a daunting endeavor. Last year was supposed to be the year that everyone got serious about the budget, but in the end it was business as usual. Congress agreed to the Administration's goal of $55 billion in spending cuts and then proceeded to take most of it out of defense. The budget resolution passed by Congress called for $27 billion in defense cuts, and $22 billion in domestic spending cuts, and the remainder coming from increased taxes, user fees and other receipts. In the end, however, because Congress failed to pass the reconciliation bill needed to make the domestic cuts effective, the final tally was close to $30 billion in defense cuts and less than $5 billion in domestic spending cuts. But, because the recently enacted farm bill is likely to add over $5 billion to spending in 1986, Congress' action on domestic spending is a wash, leaving defense as the only source of savings. Under these circumstances, it should come as no surprise that this year's deficit is expected to reach an estimated $220 billion instead of the $171 billion target set in the budget resolution. And we might note in passing that this six to one ratio of defense to domestic spending cuts is much less favorable to the President than the 50/50 sequestering split mandated by Gramm-Rudman-Hollings.

With this as background, Congress and the President embarked on another year of deficit reduction with no clear sense of how this might be achieved. Unlike last year, when a favorable political environment allowed serious consideration of cuts in all programs, the choices presently open to the budget committees will be severely limited. For starters, a large chunk of the budget, conceivably as much as 80 percent, will initially be placed off limits for a variety of reasons. The defense budget was cut by $30 billion this year and thus offers limited opportunities for further reductions. The President will certainly dig in his heels against further cuts in this sector and many in Congress might be reluctant to go much further as well. Social Security will be off limits for political reasons. The COLA (Cost of Living Adjustment) freeze debate became intense and acrimonious this summer and few politicians will want to revisit it for at least a year or two, and then certainly not in an election year. Finally, the recently enacted farm bill will determine farm spending over the next four years. And while this issue can be reopened, this is unlikely to happen in an election year.

For these reasons and others, it will be difficult to attract much interest or support to a comprehensive budget restraint program that relies on spending cuts in most or all programs. As a consequence, there is the very real risk that Congress will ultimately opt for a major tax increase. Recall that it was an environment such as this that led to the enactment of the Tax Reform and Fiscal Responsibility Act (TEFRA) of 1982.

Despite this grim outlook, there is a politically attractive solution to the dilemma that offers substantial long-run potential for large savings: A massive and comprehensive program of privatization of every government activity that could be performed by a private sector entity. Although comprehensive privatization is not likely to generate great savings during the next fiscal year, it could yield generous savings as we approach the end of the decade.

Already sizable savings have been generated in other countries utilizing such an approach. Great Britain, for example, has realized more than $27 billion through privatization over the past several years and expects to obtain another $20 billion in the next three.

While such potential savings are of major importance in times like these when the deficit hovers at $200 billion per year, the main public policy attraction of a privatization program is that it is more politically saleable than the usual menu of program freezes and exterminations, and service and benefit reductions. Privatization does not eliminate programs nor does it necessarily reduce services. Indeed, it may even lead to more and better service. Privatization merely changes the provider by placing a greater share of management and production responsibilities within the more efficient private sector.

The Privatization Option

The essential idea behind privatization is to identify those government services that could be more efficiently provided by the private sector. There are many variations on the theme with some involving partial privatization and greater participation by state and local governments. The general rationale behind privatization is to utilize the superior efficiency of the private sector and the competitive pressures of the marketplace to produce such services at the least cost possible. This entails no small gain because studies document that private firms often produce at prices which are substantially less than the average cost of similar services produced by the public sector.

The term privatization really covers several distinct ways in which government services can be shifted to the private sector. The three principal privatization mechanisms are load shedding, contracting-out and vouchers. Load shedding refers to the process whereby the government transfers complete financial and production responsibilities to the private sector. It is especially useful in the case of "private goods," that is, those services that business firms can finance and produce without government subsidy. However, it is of limited usefulness in the cases of public goods and income redistribution programs. "Public goods" refers to those services that would be inadequately provided by the private sector due to the problems of external benefits and costs which prevent the provider from collecting payments from those who benefit from the service. National defense, certain aspects of public health, and basic law enforcement are examples of public goods. If national defense were to be financed totally by the private sector, not enough revenues would be collected because each individual would have an incentive not to contribute, hoping to enjoy the security paid for by others.

The other two methods of privatization, contracting out and vouchers, are partial privatization methods and can be used in the presence of public goods and/or in conjunction with welfare or income distribution programs. Contracting out allows the government to establish the objectives for programs and finance their cost, but places the responsibility for actual production or service provision in the private sector. Cost savings at all levels of government have been achieved through contracting out in areas spanning from garbage collection at the local level, to medical care for the aged at the federal level. Studies estimate that the savings from contracting out are impressive. An OMB (Office of Management and Budget) analysis of 1,700 cost studies indicates that existing efforts at contracting out have resulted in an average savings of 20 percent over previous cost. However, since contracting out still contains a large government role, the perils of the political process remain. Davis-Bacon and Walsh-Healy provisions, for example, are unnecessary and costly government burdens placed on private contractors. Moreover, private contractors can become advocates of dubious public programs and aggressively lobby on their behalf. For this reason, when feasible, load shedding is a superior alternative to contracting out.

Vouchers are the third main privatization method and may represent a powerful and untapped source of budget savings. With vouchers, the government still funds and sets objectives by providing what amounts to a cash grant, tied to a specific purchase, to program beneficiaries who then purchase the specific goods or services in the marketplace from private suppliers. Food stamps and student loans are good examples of existing voucher programs. A voucher is normally provided to classes of citizens believed by the government to have insufficient income. The idea is to let the government provide the individual with the means to buy a certain amount of a particular good or service, and then let the individual shop around for the best deal he can obtain. In this way, much of the cost burden associated with administering the program is avoided.

Low-income housing assistance, for example, is a program that many analysts have recognized as being suitable for vouchers. A casual survey of the literature indicates why. A CBO (Congressional Budget Office) study, for example, found that each unit of newly constructed Section 8 public housing cost $6,000 per year, compared to a $2,300 rental voucher program that could provide the same quality housing through the private sector. Moreover, the beneficiaries would be free to live where they wanted to rather than being isolated in low-income housing projects. While vouchers have largely been confined to low-income programs, substantial opportunities exist in other areas such as education, and federal health and pension plans.

An Example: The United States Postal Service vs. Private Carriers

The potential for long-run cost savings through the privatization of government commercial enterprises can be illustrated through the example of the hypothetical sale of the U.S. Postal Service. Around the world and throughout most of our history, first class mail delivery has been the province of central government despite various forays into the business by private providers. Many Americans, for example, do not realize that the legendary Pony Express was a private company fulfilling a service that the Post Office could not provide. And even today, the Postal Service is subject to vigorous competition from the United Parcel Service (UPS) for packages and from a host of newly-created companies for express mail delivery.

Although nominally independent and allegedly self supporting, the U.S. Postal Service requires a federal subsidy of $800 million a year. However, it pays no taxes and provides inferior service. If completely privatized (load shedding), it could provide budgetary savings well in excess of its annual federal subsidy since it would become a taxpayer rather than a tax spender. Consider its private sector counterparts. They provide efficient service, earn handsome profits, and pay millions in federal taxes. With only a fraction of the total postal business, UPS, Federal Express and Purolator Courier paid $400 million in federal income taxes in 1984. The Postal Service, with a much larger revenue base, could pay over one billion dollars in federal income taxes if operated at the same standards of efficiency. But that's not the end of the story. As a potentially viable business entity, it could bring in billions of dollars if sold to the highest bidder. Generating more than $25 billion in gross revenues per year, it has limited debt and comes with extensive real estate holdings which are valued at nearly $7 billion at historical acquisition costs.

This example illustrates the three main sources of deficit reduction that can be achieved through privatization of government enterprises: (1) the end of a subsidy, (2) the creation of a new revenue source, and (3) the sale price. And although the sale price is a one time savings, by offsetting the deficit in any particular year, it leads to less government borrowing and a permanent reduction in future debt service costs. At current interest rates, a $10 billion sale price leads to $700 million in interest savings per year.

While these savings are substantial, the real potential attractiveness of privatization goes beyond the budgetary benefits and includes the opportunity for more efficient service at much lower costs and the creation of constituencies who stand to benefit directly from the change in ownership.

A recently-developed, postal-related business demonstrates the opportunities in this field that a private owner could take advantage of. A firm called American Discount Stamps is planning to sell a 22-cent U.S. postage stamp for 17 cents by affixing the stamp to a larger label that promotes a commercial product or service. The company believes that it can make a profit and offset the five cent loss per stamp by charging fees to advertisers. This indicates that lower postal prices could be obtained through a more creative marketing of the existing products.

The Postal Service is one of the most obvious candidates for privatization. A casual reading of the federal budget leads to hundreds more: Military commissaries, Amtrak, mass transportation, mortgage insurance, government vehicle fleet management, certain coast guard services, the Pension Benefit Guaranty Corporation, federal pensions, power marketing authorities, public housing, satellite launching, education, nuclear waste treatment, federal lands and land management, the Tennessee Valley Authority, electric co-ops and Veteran's hospitals are some of the ones that come quickly to mind. In addition, there are hundreds of less dramatic privatization options that could save billions more.

Potential Cost Savings

Although critics of privatization will often acknowledge the gains to the federal treasury from asset and enterprise sales, they dispute the existence of subsequent operating efficiencies that allow the private supplier to provide the same service at lower costs. Arguing that the government can do it more cheaply because it is nonprofit and free of state, local and federal taxes, these critics fail to consider the powerful discipline that the competitive market place imposes on private business, and how this discipline can translate into substantially lower costs and improved services. But based on numerous studies and cost comparisons, the record clearly demonstrates that the savings can be substantial. A recent article by Steve Hanke ("Privatization: Theory, Evidence and Implementation" in *Control of Federal Spending*) offers many examples of such savings, a few of which are listed below.

The federal government operates hundreds of loan programs and a high rate of defaults and delinquencies have often been a severe problem for government debt collectors. In 1984 alone, $7.8 billion in loans were written-off and many billions more were in arrears. Part of this problem stems from costly and inefficient collection efforts. A study found that one federal agency spent $8.72 per account to maintain and pursue debt collection, while one of the largest private collection agencies performed the same function for $3.50. Further, private firms report that it is possible to pursue collection on debts as small as $25 while the government typically wrote off debts for less than $600.

The President's Private Sector Survey on Cost Control (PPSSC) found that it cost the U.S. Army $4.20 to process a payroll check while the same function is performed by private business for $1.00.

Air traffic control in the U.S. is provided by both the Federal Aviation Administration (FAA) and by private contractors at smaller airports. For the smallest FAA tower authorization, the FAA spends about $1 million to install and about $275,000 a year to operate and maintain a tower. Private firms provide the same services for about $120,000 per year, including amortization of their original capital investment. When a private operator assumed the responsibility for operating the Farmington, New Mexico, tower, its contract was for $99,000 per year compared to the $287,000 that it had cost the FAA.

Maintenance of facilities at selected military installations was reduced by 35 percent when these functions were transferred to private contractors.

A study of federal and private hydroelectric plants for the years 1973-75 found similar differences. The cost per kilowatt hour of federal hydropower was $3.29, while private hydropower was $2.79.

The United Parcel Service handles twice as many parcels as the U.S. Postal service, charges lower rates, makes faster deliveries, and has a damage rate 80 percent lower than that of the post office.

A 1979 comparison of Amtrak with four private firms showed that Amtrak repaired 182,955 ties with an average work crew of 69, while the private firms repaired 684,339 ties with an average crew of only 26. Amtrak removed 71.8 miles of rail with an average crew of 129, while the average removed by the private firms was 344 miles with a crew of 77. The average private firm surfaced 864 miles of track with an 18 man crew, while Amtrak did 141.4 miles with a crew of 16.

Refuse collection represents a basic area of service where many municipalities have achieved significant savings by relying on private contractors. A study found that for cities with populations in excess of 50,000, private collectors were 30 percent less costly than public ones.

The Politics of Privatization

As the British have discovered, the basic thrust behind the privatization movement is its political attraction. Through the process of privatization, those in search of fiscal responsibility can disarm the claims of the powerful spending lobbies who maintain that budget cuts mean less service for the general public and hardship for the poor. Instead, privatization strives to supply the same services through more efficient private sector arrangements. As a consequence, program beneficiaries need not be alienated due to the loss of benefits and may actually gain through better service and lower prices. Just as important, the general taxpayer gains through avoidance of painful tax increases and the realization of lower deficits as privatization reduces the role of the public sector and the claims on the Treasury.

Another politically attractive dimension to a well-defined privatization program is that it easily lends itself to the development of effective, well-organized constituencies who will aggressively support it. This is in stark contrast to the kinds of pressure groups that emerge when attempts are made to achieve fiscal responsibility through the more traditional mechanism of program cutbacks and terminations In the case of the traditional budget cutting exercise, those who support fiscal restraint do so largely out of concern and good citizenship, not because they receive any direct tangible benefits from the exercise. As such, their support for the effort usually lacks the intensity needed to win. In 1985, for example, the Deficit Reduction Coalition, an organization of over 400 trade associations and companies that united to fight for budget cuts and achieve a lower deficit, disappeared as soon as the battle turned against them, and when tax reform moved to the front of the public policy agenda. In contrast, the lobbies representing program beneficiaries, whose potential losses were real, direct and often substantial, opposed the budget cutters with a relentlessness that explains why the deficit exceeds $200 billion, why federal spending consistently rises faster than our national income, and why the budget cutters almost always lose.

The process of privatization alters this balance of power by creating a whole new class of beneficiaries who stand to receive direct, tangible benefits from the change from government to private ownership and supply. Obviously, there are groups who would be opposed to privatization because it would lead to real or perceived losses for them. Program suppliers and public employee unions are likely to be the core of such a coalition.

However, they would have to confront a well-organized coalition that had just as much, if not more, at stake. As it stands now, such groups confront only the poorly organized taxpayer.

The Foreign Experience

Although Americans are just now getting interested in the issue, the trend toward privatization is a worldwide phenomenon, and some countries, notably Great Britain, are way ahead of us. For Britain and many developing countries, this interest is understandable and often born of necessity because their governments have intruded far deeper into their economies than has ours. In turn, this has led to the growing bureaucratization of their societies, rising government spending and burdensome taxes. In Europe, the public sector accounts for close to 51 percent of the gross national product (compared to 36 percent in the U.S. and 34 percent in Japan) and in several European countries the public sector exceeds 60 percent of the GNP. As a consequence, European countries are searching for new ways to reduce the growth of government while still maintaining essential services. Privatization has become the obvious alternative.

Since 1979, the U.K. has sold off 15 formerly nationalized industries, raising nearly $9 billion in net revenues. The success of this operation stemmed from its political attraction. Shares in the enterprise were made available to the public at discount prices and further price concessions were offered to employees. Political support gathered momentum as a broad base of stockholders, including public employees became owners of nationalized industries. In the British Telecom (BT) case, two million Britons became stockholders, including 220,000 BT employees. Today, few politicians would want to reverse this process since many voters are now company owners or consumers who receive the benefits of lower prices and better service.

The U. K. privatization effort was not limited to just nationalized industries. One of the most politically popular endeavors has been the sale of public housing to tenants. When Margaret Thatcher took office, more than one-third of all British families lived in subsidized, government-owned housing. The Labour party's policy of increasing the supply of public housing at below market rents was a constant source of their political support. And traditionally, the Conservative party, in its efforts to reduce the growth of public spending, supported policies that would reduce public housing construction and increase rents. Not surprisingly, this strategy was an abysmal failure as otherwise conservative sympathizers voted for the Labour party in order to maintain their housing subsidies. In addition, those on the public housing waiting list were often lured to the Labour party because of its support for increased public housing production and the promise of subsidized rents.

The Conservative Party's fortunes turned for the better when it adopted a privatization strategy. Recognizing that the home-ownership desires of the typical Briton are strong, the Conservative government of Edward Heath permitted local housing authorities to sell units to tenants at discounts of up to 50 percent from market price. Confronted with this opportunity, tenants turned their attention away from seeking rents to seeking homeownership, and the politics of government housing changed overnight. By instituting a discount program, the Conservatives outbid the Labour Party and bought out a key element of the public housing coalition. Residents gained through homeownership at discount prices, government revenues were boosted by the sales, and public spending was reduced permanently by cutting back on the public housing bureaucracy and costly rent subsidies.

Over 500,000 public housing units have been sold in the U.K. and more sales are planned. According to political observers, Margaret Thatcher's 1983 landslide success was due in part to significant vote switching among traditionally Labourite housing tenants.

Even in Japan, where the public sector takes up a much smaller portion of GNP, significant privatization efforts are underway. During the next five years, Japan's public sector will become even smaller when the government sells all or part of its stake in Nippon Telegraph and Telephone (NTT), Japan National Railways, Japan Tobacco, and Japan Air Lines. The Japanese government stands to get almost $40 billion from the partial sale of NTT. Elsewhere, Singapore raised $240 million by selling a minority interest in its airline. Turkey signed a contract with Morgan Guaranty to prepare a master plan for the privatization of 32 state enterprises and Mexico, whose government now owns more than a thousand enterprises compared to 86 in 1970, has also announced privatization plans.

Conclusion

Although the U.S. was fortunate enough not to succumb to the temptation to nationalize vast segments of its economy, it nonetheless owns and operates hundreds of commercial enterprises throughout the nation. And while the original reason for their creation may have been sound, the rationale for their continued federal ownership and subsidization may no longer exist. The Rural Electrification Administration (REA) may have been a good idea in the 1930s when large segments of rural America were without electrical power, but this problem was resolved by the 1950s. Nonetheless, the REA continues to exist and to grow larger and more costly with each passing year.

Why do we continue to subsidize these enterprises? In large part we do so because the program beneficiaries, bureaucrats, and suppliers constitute a formidable lobbying force. Privatization, by promising to deliver better service at lower prices, can help offset the pro-spending lobby and thereby tip the political balance in favor of the general taxpayer.

ARE CREDIT CARD INTEREST RATES TOO HIGH?

by
Rajni Bonnie Ohri

Recently, a number of observers have noted that since the early 1980s, interest rates on bank credit cards have edged up even though market rates, which represent funding costs, have fallen substantially. Some commentators may have misinterpreted the resistance of credit card rates to downward pressure as an indication that the market for credit card lending is not competitive – a premise that underlies the legislation currently pending in Congress. Although the stickiness of rates might lead some to conclude that competition is lacking in this area, other characteristics of the market suggest that competition is, in fact, intense: There are thousands of card issuers, millions of cards in circulation, and varied entrants with new products surfacing frequently.

Like all attempts to interfere with the operation of an efficiently working market, a federally mandated ceiling on credit card interest rates would have serious effects on the U.S. economy if it prevented interest rates from rising to market-clearing levels. From extensive experience with state-imposed limits and the imposition of credit controls in 1980 (which led to a sharp contraction in consumer spending), we know that regulatory measures can, at times, have unpredictable and undesirable consequences. The evidence suggests the possibility of a reduction in the supply of credit in proportion to the degree of restraint imposed by the ceiling. The reduction in credit availability could take the form of a shift in credit flows away from consumers to other sectors of the economy in an attempt to avoid the ceiling. Empirical evidence also indicates that a below-market usury ceiling would lead to nonprice credit rationing by lenders who would discriminate against low- and moderate-income borrowers and small businesses. Finally, imposition of a legal limit on interest rates runs contrary to the trend toward credit market deregulation embodied in the Depository Institutions Deregulation and Monetary Control Act of 1980.

Two legislative proposals currently exist in Congress that would establish nationwide ceilings on credit card interest rates. One of these bills, H.R. 1197, sponsored by Representative Mario Biaggi (D-NY), would limit the rate of interest on any credit card transaction to no more than five percentage points above the Federal Reserve discount rate. The other bill, H.R. 3408, introduced by Representative Charles Schumer (D-NY), would limit the interest rate on credit card debt to six percentage points above the yield on three-month Treasury bills during the previous calendar quarter. The limits imposed by H.R. 3408 would not become effective if the Federal Reserve determined that prevailing loan rates reflected the cost of funds for creditors and competition for credit card accounts. Both bills would set floating ceilings on credit card rates that would supersede generally less restrictive state-imposed limits.

Misguided Rationale for Federal Limits to Interest Rates

Although misguided, the temptation to impose federal limits on credit card rates stems from the recent U.S. experience with high interest rates. However, such measures are inappropriate because prices – in this case, interest rates – generated by the interaction of supply and demand in well-organized competitive markets, merely reflect an optimal adjustment of these forces to perceived economic circumstances, both present and future. Consequently, artificial restrictions on prices are equivalent to killing the messenger who brings bad news. The problem is not eliminated; we simply lose the benefit of the messenger's service.

Proponents of federal limits on interest rates view them as a way to prevent lenders from exploiting unsuspecting borrowers. Although this is a legitimate goal, it is not clear that interest rate ceilings do anything to promote it. In the first place, most business people do not need the "protection" afforded by interest rate ceilings because they have ample experience in negotiating credit terms on their own. Consumers and inexperienced borrowers, on the other hand, are adequately protected by truth-in-lending laws which require that the terms of credit be stated in clear, understandable language.

When interest rates discourage lending and encourage borrowing so that demand for credit is greater than the available supply at the legal ceiling rate, lenders will naturally favor the most credit worthy customers. The result is that the poor and the small, risky businesses obtain little or no credit. Those who would have credit anyway are able to borrow at lower rates, unhampered by competition from those less advantageously situated who can compete effectively only when markets are free and unrestricted. Eight independent investigations indicate that when there are usury ceilings, customers who are deemed to be poor credit risks are simply denied credit by lenders. These customers tend to be low- or moderate-income individuals or even young adults who have yet to establish credit records. These persons have no recourse but to go without credit or else obtain it from illegal sources. This nonprice rationing could be prevalent among commercial lenders as well, with adverse consequences for small businesses which rely heavily on external funds.

In fact, the most effective way to prevent exploitation in a market setting is to promote competition among sellers, especially price competition. By contrast, nonprice competition, to which usury ceilings lead, contributes to inefficiency and unfairness. Thus, usury laws in general are counterproductive because they both restrict competition and encourage discrimination by lenders.

Inefficient Business Practices

When interest rates rise, as they did after 1977, consumers, businessmen and farmers in states with restrictive interest rate ceilings find obtaining credit more difficult than do their counterparts in areas with less stringent ceilings. However, large businesses can often seek credit at alternate sources, something their smaller competitors may find difficult or impossible to do. This puts small firms at a comparative cost disadvantage and thus, hinders their ability to compete. In short, restricting competition in credit markets can actually lead to less competition in product markets.

Even those firms which can obtain credit at market interest rates in other states may resort to inefficient business practices as a result of interest rate ceilings. The best examples are firms with "big ticket" items, such as construction and agricultural equipment. Because their customers in states with usury ceilings often have difficulty securing credit, these companies attempt to compensate by offering seller financing through captive credit companies. This expansion into the business of granting credit is contrary to the principle of specialization, which is the major source of economic progress. Moreover, the lending activities of these credit companies typically reduce the overall profitability of the company's operations within the restricted states.

Is the Market Competitive?

A critical issue in any discussion of price ceilings is whether the market involved is competitive. To assess whether the market for credit cards is competitive, the adequacy of the pricing system and the evidence of what happens in the marketplace needs to be examined.

As the evidence reveals, rate disclosure in the industry appears to be effective. In the consumer credit area, a uniform system for pricing credit was established in 1968 under the principle that consumers "should be able to shop for credit just as they shop for meat and potatoes." Once effective price comparisons are possible, we should be able to assign control of prices of meat, potatoes and credit to the marketplace rather than to the legislature. Rates are also competitive. Although most offerings are near 18 percent, the actual available range is from 14 to 21 percent (see Table 1).

It seems as though every day additional entrants announce their intention to break into the credit card field. Sears, Shell, and Household International are all currently attempting to promote new products. There are approximately 130 million bank cards in the possession of consumers. In addition, there are over 350 million retail credit cards, 113 million oil company cards, and several million other types of credit cards. Approximately 15,000 financial institutions participate in some form of card program. In such an environment, the marketplace is a very accurate determinant of the value of the product. Any potential competitor who does not offer the appropriate value level for the cost of the product will be quickly abandoned for someone providing a better deal.

TABLE 1

Selected Credit Card Rates

Institution	Cards Offered	Annual Finance Rate (%)	Annual Fee ($)
Manufacturers Hanover	VISA MASTERCARD	17.8	20
Citicorp	VISA MASTERCARD	19.8	20
Citicorp	CHOICE	21	NONE
Bank of America	VISA MASTERCARD	19.8	18
Sovran Bank	VISA MASTERCARD	18	15
Dominion Bankshares, Inc.	VISA	18	15
First Virginia Banks Inc.	VISA MASTERCARD	18	15
Dominion Federal S&L	VISA MASTERCARD	19.8	15
First American Bankshares, Inc.	VISA MASTERCARD	18	15
Perpetual American Bank	VISA MASTERCARD	19.8	15
Maryland National Corp.	VISA MASTERCARD	18.9	18
Equitable Bancorp	VISA MASTERCARD	19.8	18
Chevy Chase S&L	VISA MASTERCARD	14	12

It is important to recognize that the disclosed rate is not the only element of competition. Focusing only on the interest rate overlooks the variety of services provided by credit cards as well as the variety of pricing systems. For example, some bank cards provide credit towards the purchase of merchandise at a discount that is based on the amount charged on the card. Some banks carry an annual fee; others do not. Available credit lines vary, as do credit standards. Thus, consumers may choose from a variety of credit card services and an array of different price systems. The stability of interest rates on credit cards does not mean the absence of competition. Services provided with a card and other pricing aspects of the card, rather than the quoted rate, may be the focus of competition.

Competition is also evidenced by various factors which determine card issuers' actions. Within the past few weeks, Manufacturers Hanover has reduced its bank card rate to 17.8 percent from 19.8 percent. Also, Sears is marketing its Discover card without an annual fee for the first two years. And Citicorp is test marketing a preapproved Visa card that waives the usual $20 fee for the first year. If markets were noncompetitive, there would be no incentive for card issuers to cut their rates or eliminate their annual fees. Nor would there be a significant barrier to retailers' assessing an annual fee.

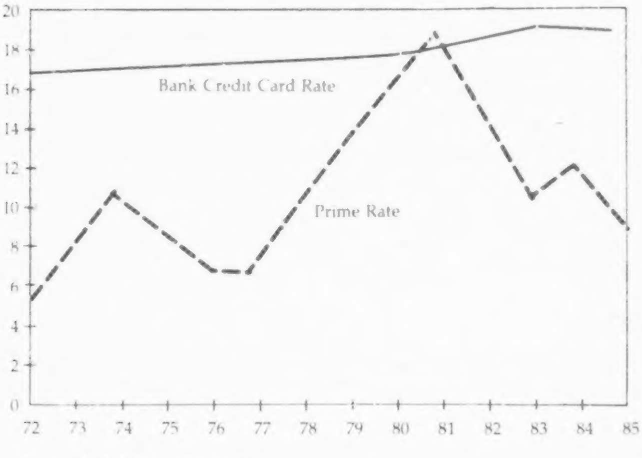
Indices of Credit Card Costs

A popular argument made concerning the current level of credit card rates is the comparison between the prime rate and the current average bank credit card rate. This, however, is the classic apples and oranges comparison. The prime rate is often referred to as the rate that banks charge their best customers for secured short-term credit. Credit card loans, in contrast, bear few of these characteristics.

Many media reports regarding credit card interest rate ceilings have created a crisis environment by tracing the relationship of average rates on bank credit cards to the prime rate from 1980 to the present. However, the evidence is faulty for the following reasons: First, selection of the base year is misleading. Deleting all information prior to 1980 conceals the fact that 1981 was an odd year in many ways, not the least of which was the very high prime rate that prevailed in that year. In August 1981, the prime rate averaged 20.5 percent; the annual rate on three-month Treasury bills was 15.5 percent. If the relationship of bank card rates to prime rates is disclosed for earlier years, the distortion introduced by viewing only the period after 1980 is apparent. As Chart 1 shows, after examining the period since 1977, there is no significant relationship between bank card rates and prime rates. The spread of bank card rates over prime rates has varied from 9.37 percent in October 1977 to -2.72 percent in August 1981 to 9.12 percent in August 1985.

Second, credit card rates and the prime rate are not properly comparable. However, comparisons are attempted because of a belief that the prime rate somehow express the costs to banks and retailers of providing revolving credit. This is not the case. The cost of funds represents only a portion of the total costs of revolving credit, and the prime rate does not adequately represent the cost of funds used by banks and retailers to finance their accounts receivable. In total, the cost of funds is only about half of the total costs of providing revolving credit. Data from the recent Functional Cost Analysis by the Federal Reserve Board show that the cost of funds comprised only 36 percent of total costs of medium-sized card-issuing banks and 40 percent of total costs of large-sized card-issuing banks.

CHART 1
MOVEMENTS IN BANK CREDIT CARD RATE
AND PRIME RATE
(1972-1985)



Source: Federal Reserve System

Clearly, over the past two decades, the credit card has come to represent a safe, secure, convenient means of payment and credit access for consumers and businesses that is almost universally accepted. In order to provide this combination of convenience and security, the bank card industry has invested heavily to develop sophisticated and costly telecommunications systems which are unique to this type of credit. These added costs contribute substantially towards making this flexible service one of the more costly forms of consumer credit.

In addition, the costs of extending open-end credit through a bank credit card are higher than through traditional installment credit. The processes differ in two key respects: risk and volume. Credit card applications are received by mail; personal interviews with the prospective customer are not typical. This aspect of credit card programs makes them inherently riskier since the customer is usually unknown to the bank. It is by definition a more risky form of credit which is susceptible to difficult collections and bankruptcy losses. The second key distinguishing factor is volume. Most bank card operations process a high volume of applications. Since over 50 percent of the dollar volume of transactions is paid off in full every month and never incurs a finance charge, card programs generate high volumes to defray enormous fixed costs associated with running such an operation.

Recently, there has developed a significant new cost to the system, that of fraud and counterfeiting. Credit card fraud losses are estimated at $80 million a year according to a recent survey by the American Bankers Association. This problem has led the industry to devote substantial resources to developing a card that is more difficult to alter. In addition, since issuers of credit cards are unsecured creditors, they seldom realize any recovery on the debts owed by consumer bankruptcies. Last year, Citicorp VISA lost over $500 million in credit card debts.

Third, proxies for the prime rate are equally unsatisfactory indices of credit costs. Just as the prime rate is not an acceptable indicator of credit costs over time, the discount rate on 90-day commercial paper at Federal Reserve banks and yields on three-month Treasury bills suffer from the same deficiencies. Both are measures of the cost of short-term money, as is the prime rate. While their fluctuations over time closely mimic movements in the prime rate, they bear little or no relationship to the total costs of providing bank or retail revolving credit. In addition, both rates are inexact measures of either marginal or average costs of loanable funds, which may reflect borrowing at a wide range of maturities. Furthermore, the discount rate is a tool of monetary policy and as such, it is an administered rate that reflects broad policy considerations that are frequently complex and so may deviate from other market rates, even those for instruments of comparable maturity.

Stability of Credit Card Rates

Viewed in the longer perspective, the question of why credit card rates have not dropped during the recent period as sharply as other rates necessarily poses the analogous question of why credit card rates did not increase in previous years when other rates surged. The stability of credit card rates reflects the lesser role of financing costs in the overall cost function. It also reflects the impact of state-established statutory ceilings on interest rates.

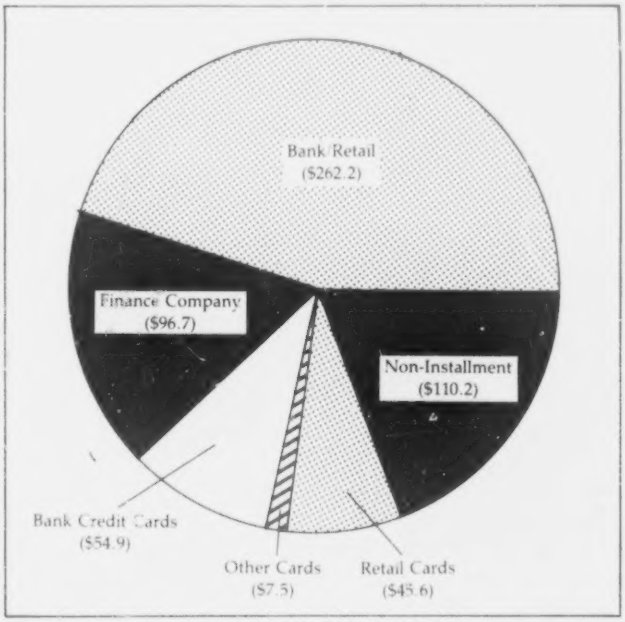
Credit card rates throughout the 1970s are not significantly different from the current average credit card rates. In the late 1970s and early 1980s, when the cost of funds significantly surpassed any previously recorded highs, credit card rates, due in many cases to usury ceilings, were unable to rise in accordance with the cost of money (in most states, 18 percent per year was the upper limit on rates that card issuers could charge on credit card balances). Yet, many institutions kept their portfolios despite losses during the period, while other providers sold their portfolios because they were a drain on bank performance. The credit card business has only recently returned to profitability, and given the reality of the market, it is clear that any effort to charge more than the market rate will be quickly undercut by scores of aggressive competitors.

Now that market funds have moved to lower levels, and credit card programs generally have become profitable again, many credit card issuers have greatly intensified their efforts to market new credit card accounts and to encourage account usage. That is, credit card issuers in general have responded to falling finance costs not by reducing rates, but mainly by increasing the availability of credit cards. This reversed the earlier curtailment of such credit that card issuers undertook as market rates moved up and they were unable to adjust revenues to match rising costs. Thus, it appears that much of the inertia in credit card interest rates may be attributable to the influence of restrictive rate ceilings imposed by the states.

Factors on the demand side of the market may also have contributed to the observed stability of credit card rates. A substantial portion of card holders either use their credit cards infrequently or usually pay off their bills in full; these holders are likely to be largely unconcerned about the level of finance charges. Even card holders who "roll over" their balances and pay finance charges may often be relatively insensitive to the rate of interest charged. Other features of credit card borrowing, such as convenience and suitability for small transactions, may outweigh any rate disadvantage. In any case, credit card debt has expanded rapidly in the last two years—a sign that consumers view credit card use as a desirable source of short-term financing despite what many observers regard as high interest rates. Indeed, cardholders will charge about $331 billion in goods and services this year, up from $293 billion in 1984 (see Chart 2).

CHART 2

CREDIT CARD CREDIT
AND TOTAL CONSUMER CREDIT
($ billions)
1984
Total Credit Outstanding = $577.1 Billion



Source: Federal Reserve Bulletin, September, 1985

Furthermore, the recent appearance of above-average returns to bank credit card lending may not lead to an immediate, widespread reduction in rates. Indeed, instead of offering lower finance rates, creditors may choose to compete by easing credit standards somewhat or by making non-interest rate credit terms more attractive.

Macroeconomic Effects of Rate Ceilings

Legislation which would restrict the ability to compete freely would only hurt the consumer by restricting the availability of a valuable array of services. Faced with a rate ceiling in a competitive market, bankers must find some means of offsetting the revenue losses from such a constraint. Banks can change their method of assessing finance charges, very likely by eliminating the "free period" and charging from the date of posting. In addition, they could raise the non-interest costs of obtaining credit by increasing the following: annual fees on credit cards, processing charges levied on each purchase or cash advance, and penalties for late payments or for exceeding the authorized credit limit. Some card issuers also may apply the reduced finance charges from date of purchase, where permitted, rather than after the grace period expires, and seek to increase the merchant discount fees. Consumers would probably react by further reducing the number of cards they hold. Such actions might very well lead to a greater concentration of bank cards in the hand of fewer banks.

In particular, banks could raise their merchant discounts; that is, the price they charge merchants to buy the bank card credit slips signed by consumers. Evidence supporting this price adjustment is found in a study conducted by the Credit Research Center of merchant discounts in Arkansas at the time all credit was subject to the ten percent usury ceiling. Whereas the average discount rates paid by retailers on bank credit cards ranged from two percent in Illinois to 3.6 percent in Louisiana, the average merchant discount paid bankers by Arkansas retailers was 5.5 percent.

Increases in merchant discounts will affect both retailers and their customers. On the one hand, small merchants carrying low-priced items would be affected more adversely than large retailers with "big ticket" items. The lower the volume of business and the lower the average sales ticket, the higher will be the merchant discount. Consequently, smaller retailers selling low-priced goods may be forced to discontinue accepting bank cards in order to remain competitive on their cash prices. Such actions will adversely affect their customers. Larger merchants, who also operate in a competitive environment, will have to pack the higher costs of accepting credit cards into their cash prices. Many consumers who purchase with cash do not have bank cards because their incomes or other indices of risk do not justify their receiving a card. Thus, cash buyers will be forced to subsidize credit buyers.

Banks may also respond to a credit card ceiling by lowering costs, especially the costs of bad debts. In other words, they will raise their credit standards and deny credit to low- or moderate-income individuals. This nonprice rationing could be prevalent among commercial lenders, with adverse consequences for small businesses which rely heavily on external funds.

Numerous studies on the impact of state-imposed usury laws on consumer and mortgage credit have all concluded that a reduction in the supply of credit below the amount which would have been offered in their absence has occurred. For example, the presence of usury ceilings on conventional mortgages within a state has been found to reduce the availability of mortgage credit and the number of housing starts within the state. For each percentage point below the estimated market-clearing rate, mortgage interest ceilings appear to reduce housing starts by 16 to 28 percent below their "free-market" levels. Business and agricultural investment in plant and equipment is probably affected in much the same way when state usury ceilings on commercial and agricultural credit are below market interest rates. Fortunately, the Federal government has permanently preempted state usury laws affecting residential first mortgage loans.

Since an adequate supply of credit is vital to the health of an economy, it follows that artificial restrictions leading to diminished credit supplies or to a misallocation of credit resources would have a deleterious effect on commerce. The only major study examining this question supports this distressing conclusion. The study estimated the macroeconomic costs to the state of Tennessee from 1974 to 1976 due to its comprehensive ten percent interest rate limitation (Richard Gustley and Harry Johnson, *Impact of the Tennessee Constitutional Usury Limit on the Tennessee Economy*, Center for Business and Economic Research, The University of Tennessee, June 1977). The study found that the state usury law resulted in an average loss of output of $150 million a year, an average loss of 7,000 jobs per year, retail sales losses of $80 million per year, and losses to financial intermediaries of $1.25 billion a year. Clearly, the economic cost to the national economy of such a law as a federally mandated ceiling on credit card interest rates would be staggering.

Conclusion

The available evidence confirms the predictions of economic theory regarding the adverse effects of interest rate ceilings. When such restrictions result in artificially low interest rates, they reduce the supply of credit and lead to inefficient, discriminatory nonprice credit rationing. These distortions impose enormous costs on the economy and discriminate against low-income borrowers and small businesses, who are forced to go without credit.

TRENDS IN COMMERCE NOTES ON TABLE II JANUARY/FEBRUARY 1986

by
Martin Lefkowitz

Gross National Product (GNP)– The Department of Commerce's preliminary estimate of the nation's economic performance as measured by Gross National Product–the value of the output of goods and services–shows that the inflation-adjusted growth rate for the fourth quarter was 2.4 percent. In the third quarter, real GNP increased by three percent. Real GNP growth over the four quarters of 1985 was 2.5 percent. The composition of GNP changed abruptly last quarter because of the plunge in new car sales, causing total consumer spending to decline by 0.2 percent, compared with an increase of 4.6 percent in the third quarter. Real final sales and real business inventory investment accounted for most of the fourth quarter increase. Within final sales, fixed investment and government purchases rose substantially, while the fall in personal consumption expenditures was the major negative factor. The star performer for the quarter was business investment which increased at a 10.3 percent annual rate.

The Services Sector– Employment in service sector establishments rose by 260,000 in December and is now 2.9 million above its year-ago level. This compares with an increase of 91,000 jobs in the goods-producing sector over the last year. Almost 97 percent of the job growth in the economy during the past year has been in services industries.

Consumer purchases of services, which comprise 51 percent of total personal consumption expenditures, rose by 1.7 percent in December. Major domestic airlines reported that revenue passenger miles flown, that is, the number of passengers multiplied by the miles flown by each passenger, reached 21.1 billion in December, an increase of 14.3 percent from last year. For all of 1985, major U.S. carriers reported an 11.3 percent increase in revenue passenger miles flown compared to 1984.

Money Supply– The nation's money supply–as measured by M-1, currency in circulation plus demand deposits–increased by 1.1 percent from November to December, nearly the same as in the previous month. Money supply growth has slowed to an 8.2 percent annual rate in the latest three-month period, but is still up 11.8 percent above its level of the last year, and remains considerably above the Fed target range of three to eight percent.

Employment – The civilian unemployment rate fell 0.2 percentage point, to 6.7 percent in January, reaching its lowest level since March 1980. The January data set new records for civilian employment which has reached 109.0 million. The percent of the adult population employed also hit a record level: 60.4 percent. Civilian employment – as measured by the monthly survey of households – increased by 397,000 persons in January (seasonally adjusted), following an increase of 237,000 from November to December. The number of nonagricultural payroll jobs – as measured by the monthly survey of business establishments – increased by 566,000 in January, the largest gain since September 1983, and included an increase of 35,000 in manufacturing jobs.

Prices – The Consumer Price Index for all urban consumers (CPI-U) increased 0.4 percent in December following a 0.6 percent jump in November. Consumer prices rose at an average annual rate of 4.2 percent during the fourth quarter, almost double the 2.3 percent rise experienced during the third quarter. The December rise, however, appears to be an aberration, not a change in the trend toward lower inflation rates that we have been experiencing for the last four years. For the second consecutive month, substantial increases in food and energy prices were responsible for the larger than average monthly increase in the CPI. Consumer prices rose by 3.5 percent in 1985, a significant improvement over 1984's 4.3 percent increase.

Wholesale prices of finished goods increased 0.4 percent from December to November and are 1.8 percent higher than their year-ago level. The major contributing factors in this increase were a surge in food prices and a rebound in auto prices.

Crude goods prices fell 0.2 percent in December, following two months of strong gains. Crude goods prices rose a total of six percent in October and November, with crude food prices jumping over 12 percent. Crude goods prices showed a 5.5 percent decline from their year-ago level, with all major categories down except construction materials. Crude energy materials fell 4.3 percent in 1985, foodstuffs and feedstuffs declined 6.4 percent and other raw materials were down 4.5 percent.

Housing Starts – Privately owned housing units were started at a seasonally adjusted annual rate of 1,840,000 in December, an increase of 17 percent from the November level. Sales of new homes surged 12.1 percent in 1985, hitting their highest level since 1979. Most of the improvement in starts and sales is attributable to steady declines in mortgage interest rates as both fixed-rate and adjustable rate mortgage rates have fallen by about 1.5 percentage points over the past year. Building permits, an indicator of future activity in the home building industry, increased 11 percent. Both housing starts and building permits have been fluctuating erratically in recent months and appear not to show a particular trend at this time.

Industrial Production – Industrial production increased by 0.7 percent in December, following a revised 0.6 percent jump in November.

The capacity utilization rate in manufacturing increased to 80.3 percent in December from 80.1 percent in November. The increase in the operating rate was widespread, with motor vehicles and parts showing the largest rise (3.6 percentage points). Manufacturing capacity rose 0.6 percent in the third quarter of 1985, a 3.0 percent increase from a year ago.

Productivity – Nonfarm business productivity fell at a 1.9 percent annual rate in the fourth quarter as moderate advances in output were outweighed by strong gains in hours (3.9 percent). For 1985 as a whole, productivity was unchanged in nonfarm business, and was up by 2.7 percent in the manufacturing sector.

Interest Rates – The prime interest rate, which still remains at 9.5 percent, is one percentage point below the rate prevailing at this time last year. The three-month Treasury-bill rate fell by 0.3 percentage points from December 3 to January 31, 1986. Thirty-year Treasury bonds have fallen by 0.6 percentage points during the same period.

Business Failures and Formations – Dun and Bradstreet's Index of Business Failure indicates that business failures for the first 11 months of 1985 were up over ten percent from the same period in 1984, and that total business closings rose by about 14 percent.

Dun and Bradstreet reported that 334,831 new business corporations were formed in the first six months of 1985, an increase of 2.8 percent from 1984. Seven of the nine census regions had an increase in new business corporations formed in the first six months of 1985 compared to 1984. The New England and South Atlantic regions reported the largest gains in incorporations, while the Pacific and West North Central regions reported declines. There were 1.9 percent fewer new business corporations formed in June of 1985 as compared to June 1984, with 15 states reporting declines of over ten percent.

Federal Spending – The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, increased by 8.4 percent in December compared to its year-ago level. Federal receipts for the first three months of the fiscal year increased by 6.7 percent, while expenditures for the same period rose by 6.4 percent. The federal deficit for the first quarter of fiscal year 1986 stood at $76.7 billion compared to $72.4 billion during the first quarter of the last fiscal year.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Nov/85	240.1	239.9	237.9	0.1	0.9
Gross National Product ($B)	IV/85	4,075.1	4,016.9	3,825.5	1.4	5.8
Gross National Product (82$B)	IV/85	3,605.0	3,584.1	3,515.6	0.6	2.5
Money Supply (M1) ($B)	Dec/85	624.7	617.9	558.5	1.1	11.9
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Dec/85	2,675.1	2,621.6	2,503.4	2.0	6.9
Personal Consumption Expenditures (82$B)	Nov/85	2,317.3	2,312.8	2,265.4	0.2	2.3
Disposable Personal Income ($B)	Dec/85	2,878.6	2,837.8	2,737.8	1.4	5.1
Disposable Personal Income (82$)	Nov/85	2,508.4	2,510.2	2,481.1	-0.1	1.1
Personal Savings Rate (%)	Dec/85	3.7	4.2	5.6	-0.3[b]	-1.9[b]
Civilian Employment (millions)	Jan/86	109.0	108.2	106.4	0.7	2.4
Civilian Unemployment Rate (%)	Jan/86	6.7	6.9	7.4	-0.2[b]	-0.7[b]
Average Hourly Earnings	Dec/85	$8.75	$8.67	$8.47	0.9	3.3
Consumer Price Index (All Urban, 67=100) [a]	Dec/85	327.4	326.6	315.4	0.4	3.8
Purchasing Power of the Dollar (67=$1.00) [a]	Dec/85	0.305	0.306	0.317	-0.3	-3.8
Prime Interest Rate (%) January 31, 1986		9.5	9.5	10.5	0.0[b]	-1.0[b]
Retail Sales ($)	Dec/85	117.9	115.6	110.5	1.9	6.6
SERVICES SECTOR						
Employment in Services (Millions)	Dec/85	73.9	73.7	71.0	0.3	4.1
Consumer Purchases of Service ($B)	Dec/85	1,363.7	1,341.3	1,263.7	1.7	7.9
Consumer Purchases of Service (82$B)	Nov/85	1,128.5	1,122.7	1,107.1	0.5	1.9
Revenue Passenger Mileage Flown Major Airlines (Billions) [a]	Dec/85	25.7	22.2	22.7	15.8	13.2
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B) [a]						
Before Tax [a]	III/85	228.6	218.7	227.7	4.5	0.4
After Tax [a]	III/85	141.1	136.4	140.3	3.4	0.6
Industrial Production (77=100)	Dec/85	126.0	125.1	123.3	0.7	2.1
Capacity Utilization Rate (Mfg.) (%)	Dec/85	80.3	79.9	80.9	0.4[b]	-0.6
New Housing Starts (thou. units)	Dec/85	1,840.0	1,566.0	1,630.0	17.5	12.9
Net Business Formation (67=100) [a]	Dec/85	115.1	117.1	116.6	-1.8	-0.4
New Business Incorporations (Thousands)	Jul/85	53.9	55.3	52.1	-2.5	3.5
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77=100)	IV/85	169.8	167.6	163.6	1.3	3.8
Unit Nonlabor Costs (77=100)	IV/85	160.1	161.8	158.9	-1.1	0.8
Producer Price Indices (67=100)						
Crude Materials	Dec/85	304.7	305.6	322.4	-0.2	-5.5
Intermediate Goods	Dec/85	318.8	318.1	319.9	-0.4	-0.3
Finished Goods	Dec/85	297.2	296.7	292.0	0.4	1.8
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67=100)	Dec/85	640.2	645.4	590.7	-0.8	8.4
Federal Government Debt Outstanding ($B) [a]	Sep/85	1,827.4	1,822.4	1,576.7	0.3	15.9
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	IV/85	369.7	363.2	389.5	1.8	-5.1
Imports of Goods & Services ($B)	IV/85	466.9	451.0	461.7	3.5	1.1
Balance on Goods & Services ($B)	IV/85	-97.2	-87.8	-72.2	10.7	34.6
WHAT'S AHEAD?						
Index of Leading Indicators (67=100) [a]	Dec/85	173.6	172.0	164.1	0.9	5.8

NOTES: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted

[b] Percentage point difference

Personal Savings – In December, the personal savings rate was 3.7 percent of after-tax income, an improvement from the 2.8 percent rate reached in October. Personal savings were $106.1 billion in December, compared with $120.3 billion in November. For 1985 as a whole, savings as a percent of disposable income fell to an all-time low of 4.6 percent.

Retail Sales – Retail sales increased by 1.9 percent in December following a revised 0.7 percent increase in November. Sales were up 6.6 percent from their year-ago level. Much of the December rise was due to a 5.7 percent gain in auto sales, prompted by dealer incentives. Fourth quarter retail sales were 0.7 percent below the third quarter but were 5.6 percent above the same quarter a year ago. Durable goods sales in December increased 9.3 percent from their year-ago level; automotive sales rose ten percent from last year's level. December nondurable goods sales increased 0.6 percent from November and 5.1 percent over its year-ago level.

Trade Deficit – The trade deficit continued to increase in the fourth quarter, reaching $148.5 billion for 1985 as a whole. On a goods and services basis, the trade deficit averaged $97 billion in the fourth quarter, compared to $88 billion in the third quarter. For the year, the trade deficit on a goods and services basis was $74.4 billion, an increase of $15.2 billion from 1984. On a monthly basis, the December merchandise trade deficit reached a record $17.3 billion, the highest monthly deficit in history. Most of the increase in the 1985 trade deficit was attributable to lower exports rather than a higher level of imports. For the full year, imports rose six percent from their year-ago level while exports fell 2.2 percent.

What's Ahead – The composite index of leading indicators, designed to predict future movements in aggregate economic activity, posted its eighth consecutive monthly increase in December, rising by 0.9 percent. Higher stock prices, an increase in the number of building permits issued and a longer factory workweek were the major reasons for the gain in the index. The 5.8 percent increase in the index for all of 1985 was significantly greater than the 0.4 percent increase in 1984.

NATIONAL CHAMBER FOUNDATION PUBLICATIONS

The following is a description of published studies available through the National Chamber Foundation (NCF), a public policy research organization affiliated with the U.S. Chamber of Commerce. The National Chamber Foundation conducts studies on emerging economic issues of importance to the business community. NCF is dedicated to action-oriented projects providing needed analysis on important issues, outlining policy options, and ensuring that these options are translated into action.

Self-Discipline, Schools and the Business Community

This joint effort by the National Chamber Foundation and the Council on Trends and Perspective, examines the apparent failure of America's education system to teach basic workplace skills, such as self-discipline, organization, and analysis. The report was prepared by noted sociologist, Dr. Amitai Etzioni. ($8.50)

Strategies for Hispanic Business Development

This three monograph report, the culmination of a three-year study, examines the past growth, current status and future potential of the Hispanic business community in the United States, a segment largely unknown to or misunderstood by American business as a whole. The report's author, Dr. Richard Arellano, a former State Department official, states that the Hispanic business community is an underutilized national resource with tremendous potential. It is clearly in the interest of the entire nation to see the Hispanic business sector reach its full potential. NCF's report details specific actions which should be undertaken by the Hispanic community, the American business sector and the U.S. government to achieve this end. ($30.00)

Immigration, Refugees and American Business

America's immigration problem is rapidly reaching crisis proportions. Dr. Michael Teitelbaum's *Immigration, Refugees, and American Business* dissects this complex issue and analyzes how current U.S. immigration policy affects our nation's business community. The report recommends new private and public sector approaches to this controversial problem. ($8.50)

Making U.S. International Economic Policy

This report discusses ways that the United States can better coordinate the various aspects of its international trade policies, much the same way that it now coordinates all decisions affecting our nation's defense. Robert Hormats, formerly Deputy U.S. Trade Representative, is the author of the report, which NCF released in March 1984. ($6.50)

National Health Care Strategy

Five monographs entitled: How Business Interacts with the Health Care System-How Business Can Use Specific Techniques to Control Health Care Costs-How Business Can Stimulate a Competitive Health Care System-How Business Can Promote Good Health for Employees and Their Families-How Business Can Improve Health Planning and Regulation. ($20.00 per set; $7.00 for individual monographs)

The Law of Product Liability: Problems and Policies

This study, prepared by the Legislative Drafting Research Fund of Columbia University, examines ways of making our nation's product liability laws less burdensome to industry without endangering the consumer. Preliminary drafts of the report convinced the Department of Commerce to revise its proposed model product liability law for the states. ($22.95 for hard cover; $15.95 for soft cover)

The Impact of the 1981-1982 Investment Incentives on Business Fixed Investment

This timely study, prepared by Dr. Michael Boskin, Professor of Economics at Stanford University, examines the impact of the investment incentives in the 1981-82 tax acts on business fixed investment in the United States. His findings reveal that investment incentives *do* work and that this should be carefully considered in any tax reform proposal. ($10.00)

To order copies of these publications, or to obtain further information about the National Chamber Foundation, please contact: National Chamber Foundation, 1615 H Street, N.W., Washington, D.C. 20062, (202) 463-5552.

THIRD-QUARTER PERSONAL INCOME STATISTICS SHOW GAINS

The U.S. Department of Commerce reported that third quarter nonfarm personal income rose 1.1 percent. Those states which posted the largest gains are in New England and the South. New Hampshire showed the biggest improvement with a 2.1 percent gain, representing almost twice the national average. Large gains in personal income were also reported in South Carolina, Georgia, Tennessee, and Massachusetts.

Mississippi suffered the sharpest decline in personal income, a two percent drop, which was partially blamed on the damage to residential property caused by Hurricane Elena. Other states which showed declines or no change in personal income were Montana, West Virginia and Maine.

HELP-WANTED INDEX RISES

The Conference Board reported that its help-wanted advertising index rose one point in December from the previous month to 145, its highest level of last year.

The seasonally adjusted index, which uses the 1967 level as its base of 100, matched the year earlier figure. The index measures classified advertising in 51 major U.S. newspapers and is regarded as an indicator of demand for labor and of general business conditions.

The index, which measured 139 in January 1985, declined to the year's low of 131 in April and May. The sharpest gains in help-wanted advertising occurred in Dallas, Houston, and San Antonio, Texas; New Orleans, Louisiana; and Oklahoma City and Tulsa, Oklahoma. Advertising declined in parts of the West and New England.

PER CAPITA TAXES UP NEARLY TEN PERCENT IN 1984 REPORTS CENSUS BUREAU

The Census Bureau reported that per capita federal, state, and local government taxes in fiscal year 1984 rose 9.4 percent over 1983. Taxes collected by the three levels of government totaled $3,112 per person, showing an increase of $267 over the previous period. The federal government share of total tax revenues was 56 percent, the state government share was 27 percent, and the local government share, 17 percent.

The states which showed expenditures by state and local governments accounting for more than one-half of government spending below the federal level in 1984 were: California ($74.1 billion), New York ($65.0 billion), Texas ($35.3 billion), Illinois ($27.2 billion), Pennsylvania ($26.6 billion), Ohio ($25.4 billion), Michigan ($25.4 billion), and Florida ($23.4 billion).

WHAT DO 100 JOBS MEAN TO A COMMUNITY?

The findings of a 1984 study conducted by the Economic Policy Division have been published in *What 100 New Jobs Mean to a Community* which details the economic benefits, in terms of new businesses, nonmanufacturing jobs, increased personal income, an improved tax base, and much more, to a community when the manufacturing base is expanded.

The book outlines important strategies for communities trying to attract new manufacturing firms. According to the publication, a key element of attracting businesses to a community is to adopt fiscal and tax policy measures which favor industrial expansion thereby creating a healthy climate for business.

Copies of this informative study may be ordered by calling Susan Holliday, Special Products Division, (202) 463-5755.

AREA SURVEY PREDICTS GROWTH IN MANUFACTURING

The latest survey of manufacturers conducted by the Federal Reserve Bank of Philadelphia during the month of October shows that 52 percent of area manufacturers report no change in the rate of their operations, 22 percent report increasing activity, and 17 percent say business was slower for the month of October than in September.

With regard to specific measures of manufacturing activity, survey respondents noted some improvement in shipments and new orders. They reported that the level of unfilled orders had fallen off slightly, along with employment and working hours. The report states that October marks the tenth month in a row in which the number of firms reducing payrolls has exceed the number adding payrolls, the longest such period in a nonrecession year. Despite this, manufacturing activity has either held steady or increased during these months.

In the near term, positive views prevail among the survey participants. Forty-three percent of the companies who participated expect improved business conditions over the next six months, compared to only 22 percent who are concerned that business conditions might decline. These companies forecast increases for new shipments, orders, and to a lesser extent, capital expenditures.

The majority of survey respondents report a steady trend in industrial prices, with no changes in the cost of either raw materials or the products they manufacture. Between now and March 1986, over half of the participants anticipate higher input costs, and 40 percent say they plan to charge more for their products.

POPULATION GROWTH OF 10 LARGEST METROPOLITAN STATISTICAL AREAS
1983–2000
(Millions)

	Population		
	1983	2000	Percent Change 1983–2000
West Palm Beach/Boca Raton, FL	659	1063	61.3%
Phoenix, AX	1664	2573	54.6
Orlando, FL	793	1194	50.5
Riverside/San Bernardino, CA	1738	2465	41.9
Salt Lake City/Ogden, UT	1006	1363	35.5
Denver, CO	1562	2109	35.0
Tampa/St. Petersburg /Clearwater, FL	1770	2388	34.9
Houston, TX	3161	4262	34.8
Sacramento, CA	1197	1608	34.3
Fort Lauderdale/Hollywood /Pompano Beach, FL	1073	1431	33.3

Source: U.S. Department of Commerce, Bureau of Economic Analysis

The metropolitan areas which are projected to grow the fastest are located primarily in the southern section of the country, and those projected to experience the slowest growth rates are located in the Northeast and Great Lakes regions.

The nation's population is expected to grow by 14 percent between 1983 and 2000, and the fastest-growing metropolitan area in terms of population growth will be in West Palm Beach, followed by Phoenix and Orlando. Population in Cleveland is expected to fall by 8 percent, while in Detroit and Pittsburgh it is expected to decline by 2 percent. All other metropolitan areas are projected to experience population increases. The 10 metropolitan areas with the fastest projected population growth are located in the states of Florida, California, Texas, Arizona, Colorado and Utah.

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ECONOMIC OUTLOOK

Chamber of Commerce of the United States
March 1986

OIL PRICES, THE DOLLAR AND THE U.S. OUTLOOK

by

Graciela Testa-Ortiz

The convergence of two events, the continued decline in the value of the U.S. dollar and the collapse of oil prices, has significantly improved the outlook for the U.S. economy. To be sure, both of these occurrences have advantages and disadvantages. For instance, while the dollar's strength during much of this decade wreaked havoc with our exporting industries, it also contributed to the deceleration in the rate of growth in consumer prices. Similarly, while the inflationary shocks resulting from the 1973 and 1979 increases in oil prices dampened economic activity worldwide, it was certainly a boon for the domestic oil and related industries and regions. Despite the pluses and minuses associated with these two events, we believe, as this article explains, that they will be a net plus for the United States economy.

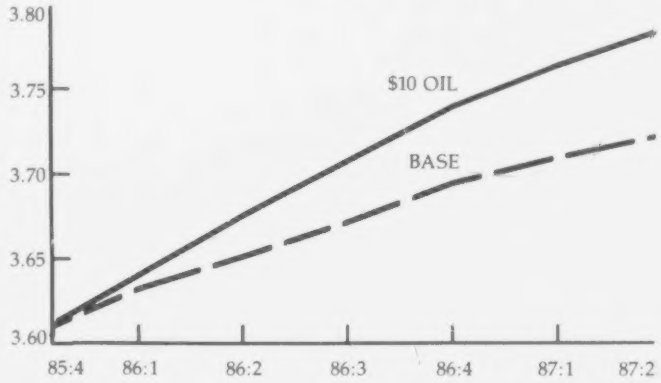
Lower Oil Prices: Domestic Impact

During the 1970s, the U.S. economy was characterized by spiraling rates of inflation, caused, in part, by the 1973 and 1979 oil price shocks, and increases in other commodity prices. Although the dramatic reduction in inflation during the 1980s reflects several developments, including monetary restraint, the slide in petroleum prices, from a peak of $35 per barrel in early 1982 to an average of $28 per barrel in 1985, contributed to some measure of price stability.

After studying the issue extensively (see ECONOMIC OUTLOOK, March 1983 and May 1984 issues), we have concluded that despite the negative impact on the domestic oil industry and the regions which are dependent on the energy sector, the decline in petroleum prices is a welcome shot in the arm for the American economy as a whole.

Table 1 shows the results of our econometric analysis of the impact on the U.S. economy of a $10 per barrel drop in the price of oil. A sustained $10 drop raises the *level* of real gross national product (GNP) by 0.8 percent in the first year and 1.6 percent in the second year compared to what would otherwise have been the case (see Chart 1). In terms of *growth rates*, this means that the oil price decline adds 1.2 percentage points to real GNP growth in 1986 and 1.0 percentage point in 1987.

CHART 1
IMPACT OF A $10 PER BARREL DROP IN OIL PRICES ON REAL GNP
(trillions 1982$)



IN THIS ISSUE

Oil Prices, the Dollar, and the U.S. Outlook .... p. 1
Forecast Table .... p. 8
It's Time to Restore Presidential Budgetary Power ..... p. 9
Pressure for Change in Financial Markets .... p. 11
Trends in Commerce .... p. 15

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TABLE 1
ECONOMIC IMPACT OF A $10 PER BARREL DROP IN THE PRICE OF IMPORTED OIL
(percentage difference from base unless otherwise indicated)

	1986	1987
GNP	0.5	0.8
Real GNP	0.8	1.6
Consumption	0.8	1.4
Nonresidential Investment	1.3	3.0
Residential Investment	2.1	4.1
Civilian Employment	0.4	0.9
Consumer Prices (1)	−1.1	−0.3
Implicit GNP Deflator (1)	−0.4	−0.4
3-Month Treasury-Bill Rate (2)	−30.0	−20.0
Corporate Bond Rate (2)	−10.0	−20.0

Note: The base simulation is the January Laurence H. Meyer and Associates (LHM&A) forecast (BASE601). The price of OPEC oil is $20 per barrel in both 1986 and 1987. The alternative simulation assumes that OPEC oil averages $10 per barrel in both 1986 and 1987.

(1) Percentage point difference.

(2) Basis point difference.

Source: U.S. Chamber of Commerce, Forecasting Section, using the Washington University (LHM&A) model of the U.S. economy.

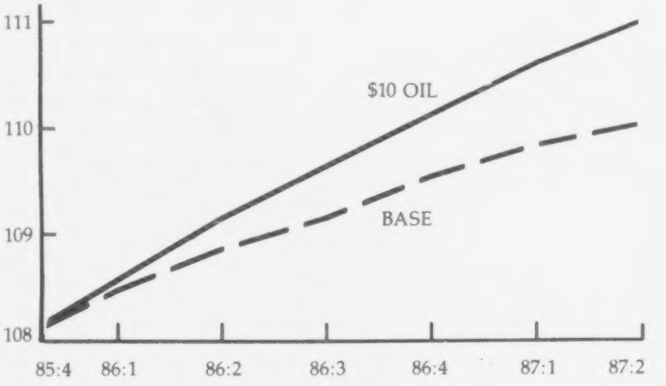
Furthermore, our analysis shows that the rate of growth of the consumer price index will decline by 1.1 percentage points in 1986 and 0.3 percentage points in 1987. Lower inflation, and reduced expectations of future inflation, will contribute to lower interest rates. Indeed, domestic as well as foreign interest rates have already declined significantly.

As interest rates fall, the outlook for credit-sensitive sectors, i.e., housing, automobiles and consumer durables, will strengthen considerably. This improvement will, in turn, bolster the outlook for those industries that supply these sectors, such as metals, textiles, electrical machinery, and stone, clay and glass. The drop in oil prices is a plus for energy-intensive industries, including the chemicals, plastics, steel and fertilizers industries, which bore the brunt of the price shocks of the 1970s. Furthermore, other industries, such as metals, cement and paper products, will benefit from the drop in residual fuels prices. The transportation sector, which accounts for 65 percent of U.S. oil demand, will be a major beneficiary, and all industries will eventually benefit from lower transportation costs.

The combination of lower energy costs and lower rates of interest will spur investment, both in the residential and nonresidential sectors. As a consequence, nonresidential investment should be 1.3 percent higher in 1986 and three percent higher in 1987 than would otherwise have been the case. Similarly, residential investment is anticipated to rise by 2.1 percent and 4.1 percent, respectively.

Higher levels of investment mean that more private sector jobs are created. As a result, civilian employment is 0.4 percent higher in 1986 and 0.9 percent higher in 1987 than would otherwise have been the case (see Chart 2).

CHART 2
IMPACT OF A $10 PER BARREL DROP IN OIL PRICES ON CIVILIAN EMPLOYMENT
(millions)



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Ms. Rajni Bonnie Ohri, Economist.

Reduced business costs will find their way to consumers through a variety of channels. The most obvious improvement will be in the price of gasoline, heating oil, and electricity. In particular, consumer energy expenditures, which account for over seven percent of total consumer spending, will decline. Lower prices and higher employment raise real disposable income and consumer purchasing power. Consequently, consumer spending will be 0.8 percent higher in 1986 and 1.4 percent higher in 1987 than would have been the case without the oil price reduction. In particular, discretionary spending, on items such as household furnishings, automobiles and recreational and leisure activities, should improve. As a result, tourism-related industries can also be expected to benefit.

Not everyone will benefit, however. Texas, Oklahoma and Louisiana, whose local economies were cushioned from the past two recessions by their oil riches, are feeling the pain of adjustment to lower oil prices. However, the decline in oil prices did not come as a surprise. Last month's sharp drop was the fifth decline in three years. The domestic oil industry is simply continuing a process of adjustment which began then. Clearly, economic activity in these states and in oil-related industries will remain weak. Oil service industries, such as manufacturers of drilling equipment, are likely to be the hardest hit as the fortunes of the domestic oil industry decline. Despite this outcome, which is already manifesting itself, the drop in oil prices represents a net plus for the economy as a whole.

Lower Oil Prices: International Impact

Tumbling oil prices improve the economic outlook for the world economy as well. A $10 per barrel decline in the price of oil is estimated to raise real gross national product in the OECD (Organization for Economic Cooperation and Development) nations by about one percent. Similarly, it cuts average OECD inflation by between one percent to 1.5 percent, which allows interest rates to fall by about the same percentage. The resulting increase in world trade should benefit all nations, oil exporters and oil importers alike. For the United States, it means an increase in foreign demand for U.S. goods and services, thus buoying real export growth. Together with the decline in the value of the dollar, this will help narrow the trade gap.

Japan, which imports all of its crude petroleum and whose domestic energy requirements are dependent on petroleum-derived products, will be a major beneficiary of the oil price drop. By one estimate, the decline in oil prices spells the difference between a growing economy and the "mild growth recession" that had been forecast for that country. In spite of the fact that the oil price decline will reduce Great Britain's oil revenues, the net effect on its economy will be positive. This results from an increase in nonoil exports as the economies of its major trading partners strengthen. France, West Germany and Italy, all major oil importers, will enjoy substantially lower rates of domestic inflation and stronger growth. As is the case with Great Britain, Canada's energy sector will experience losses and cutbacks in investment. Nevertheless, nonoil exports will benefit. In particular, the improvement in U.S. economic activity represents an important boost to the Canadian economy since exports comprise 30 percent of Canadian GNP and the U.S. is its largest overseas market.

The biggest winners, however, will be the oil-importing nations: Brazil, South Korea, Taiwan, Greece, the Philippines, Chile and Uruguay. Not only will their oil import bill be reduced, but the increase in international trade, which will accompany a growing world economy, and decline in interest rates, which will result from lower inflation, mean that (1) their current account position will improve and (2) their debt service burden will decline. The indebted oil exporters—Venezuela, Nigeria, Mexico, Algeria, Indonesia, Malaysia, Ecuador and Egypt—will see a deterioration in their current account position as oil revenues drop, but they too will benefit from an increase in nonoil exports and a decline in their debt service burden.

While it is estimated that Mexico will lose about $3.6 billion in oil revenues from a $10 per barrel drop in the price of oil, it will gain about $1 billion from the reduction in its debt service burden which should result from falling interest rates. Estimates by American Express Bank show that with the price of oil at $20 per barrel, Brazil, the world's largest debtor country and an oil importer, saves $1.7 billion in oil charges and $1 billion in interest charges. World Bank estimates show that oil prices in the $17 to $18 per barrel range signify an $80 million saving on Chile's oil bill and a $60 million saving on Uruguay's oil bill. To this saving should be added the positive impact of increased exports and lower debt service burdens. It should be noted that both Mexico and Brazil have already been successful in securing lower interest terms in their latest meeting with their creditors.

Serious concern has been expressed regarding the impact of the oil price drop on the banks which have loans outstanding to the domestic oil industry and the indebted oil exporters. The fear is that the oil price decline might prompt a rash of defaults, including the likelihood that a major debtor country might default on its obligations. This raises the possibility that, in order to avoid bank collapses, the Fed will have to significantly increase the supply of money, thus risking a reacceleration of domestic inflation.

While the danger should not be taken lightly, this view fails to take account of several mitigating factors. In 1982, when the developing country debt became a serious problem, the world economy was in the midst of a serious recession and bank profits were weak. This time around, the U.S. economy is in its fourth year of a strong recovery and bank earnings have increased in tandem with the improvement in economic activity. Furthermore, the banks with the greatest exposure to the major debtor countries have used the past four years to strengthen their positions by raising their ratios of primary capital to assets and reducing the share of problem debts to total assets. As a result, they are in a significantly stronger position now than they were in 1982.

Although the oil price decline means that banks will probably have to make concessions to nations such as Mexico, it also means that the ability of the oil importing debtors to service their debts has improved markedly. This was not the case in 1982 when both the oil exporting and the oil importing debtors were facing a bleak future. As a result, it should now be easier for the banks to grant concessions to Mexico, for instance, since it is unlikely that they will have to do the same for all debtors.

Lower Oil Prices: How Low and for How Long?

These benefits from lower oil prices are predicated upon a sustained drop in the price, that is, that oil prices will settle at a level $10 per barrel lower. Some analysts have expressed concern that the price drop will so stimulate oil consumption that the resulting increase in demand will push prices back up. They have also noted that the sharp slide in prices may force the OPEC member countries to restrict output, thus raising prices.

The imbalance between supply and demand of petroleum is nothing new; excessive OPEC production has been placing downward pressure on prices since 1982. Although a sharp rebound followed the four previous price collapses, it seems likely that this will not be the case this time around. In spite of expectations of stronger economic growth in the industrial nations, it is unlikely that demand will increase markedly.

Petroleum demand is still responding to the price increases of the 1970s. U.S. demand, which accounts for one-third of free world consumption, actually fell by two percent between 1982 and 1985, even though 1985 real GNP was 11 percent higher than in 1981, and real crude oil prices were 35 percent lower. Thus, industry experts do not expect final demand to exceed 16 million barrels per day during 1986. An analysis of the sources of demand – inventory build-up, the transportation sector, public utilities, industrial users, etc. – shows why demand is likely to remain weak.

As prices fell last month, stocks were quickly replenished, so inventory demand will remain weak. The move toward energy conservation prompted by the price increases of the 1970s has *permanently* reduced petroleum demand. For instance, two significant conservation measures were the move towards better insulated homes and more fuel efficient cars. It is unlikely that as a result of the drop in oil prices, new homes will be built with less insulation or that improvements in the fuel efficiency of new cars will be reversed.

Important sources of demand for petroleum in the United States are the transportation and utilities industries. Even though a reduction in gasoline and diesel fuel prices will stimulate demand from the transportation sector, improved fuel efficiency will dampen any increase. Since the nation's utilities have increased their use of gas and nuclear power, petroleum remains the swing fuel, used only during peak-load periods, and then only when gas is not available. Therefore, as long as gas prices remain competitive (and the deregulation of natural gas assures that declines in gas prices will accompany declines in oil prices), demand for oil from the utilities will remain substantially unresponsive to price changes. Industrial users of energy also reacted to the price increases of the 1970s by engaging in projects geared toward reducing energy consumption. Since most of those are now complete, it is unlikely that industrial consumption of oil will surge as a result of lower prices.

Because a substantial increase in demand is not forthcoming, a rebound in prices would only be likely if supply were curtailed. But OPEC's attempts of the past three years at maintaining production quotas have been unsuccessful. Debt-ridden oil exporters continue to pump as much oil as possible in order to service their debts, leaving Saudi Arabia to bear the burden of production cuts. Saudi Arabia has made it abundantly clear that it is no longer willing to play the role of swing producer. Industry analysts point to the fact that Saudi Arabian production costs are so low that it "generates as much net revenue by selling seven million b/d at $14 per barrel as by selling 3.5 million b/d at $27." Further, OPEC's efforts at cajoling non-OPEC producers to curtail production are bound to fail, since most non-OPEC oil producing nations are net oil importers who stand to benefit from lower oil prices. The only countries who might ally themselves with OPEC are Mexico and the Soviet Union. However, these two countries together export only about 2.5 million barrels per day of crude oil. Even if they cut their production by one half, their impact on world oil markets will be insignificant.

The Arguments Against an Oil Import Fee

In spite of the overwhelming evidence as to the benefits of the oil price decline, many will have us believe that we must "protect ourselves" from it through the imposition of an oil import fee. Our detailed analysis of such a fee has determined that it would diminish the growth prospects of the American economy.

Table 2 summarizes the results of an econometric simulation of the impact of a $5 per barrel import fee performed by the consulting firm of Laurence H. Meyer & Associates (LHM&A). The static revenue increase resulting from the fee is estimated to be $10.1 billion in 1986 and $10.8 billion in 1987.

TABLE 2

ECONOMIC IMPACT OF A $5 PER BARREL OIL IMPORT FEE
(percentage difference from base unless otherwise indicated)

	1986	1987
Real GNP	−0.2	−0.5
Consumption	−0.2	−0.4
Nonresidential Investment	−0.3	−0.7
Residential Investment	−0.4	−0.7
Civilian Employment	−0.1	−0.3
Civilian Umemployment Rate (1)	+0.1	+0.2
Consumer Prices (1)	+0.6	+0.2
Implicit GNP Deflator (1)	+0.5	+0.2

(1) Percentage point difference.

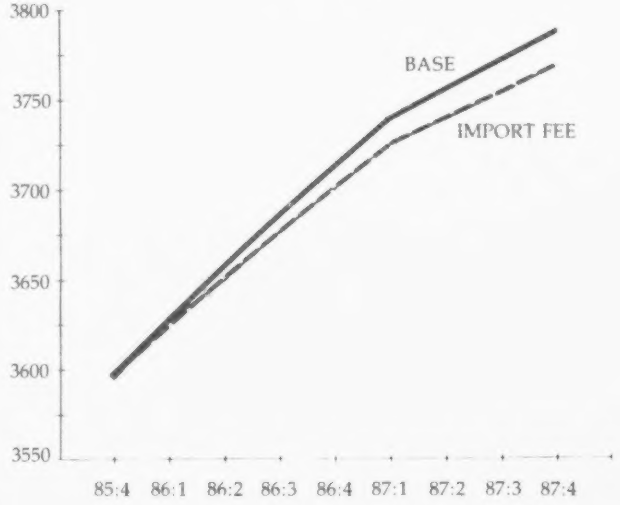
Source: Laurence H. Meyer and Associates, from a special analysis prepared for LHM&A clients.

Enactment of such a tax would increase inflation, thus lowering overall economic activity and partially offsetting the gains stemming from the slide in oil prices. The rate of growth of the consumer price index is anticipated to be 0.6 percentage points higher in 1986 and 0.2 percentage points higher in 1987 than would otherwise have been the case. The analysis assumes that the Federal Reserve, realizing that the rise in inflation is due to the import fee and does not represent a renewal of inflationary pressures, provides enough additional reserves so as to maintain interest rates at approximately the same level as in the base simulation. If the Fed does not accommodate the new tax, however, the negative impact on the economy would be larger.

If the import fee is enacted, the *level* of real GNP can be expected to be 0.2 percent lower in 1986 and 0.5 percent lower in 1987 than would otherwise have been the case (see Chart 3). As a consequence of reduced economic activity and higher prices, consumer spending and residential and nonresidential fixed investment would also decline.

CHART 3

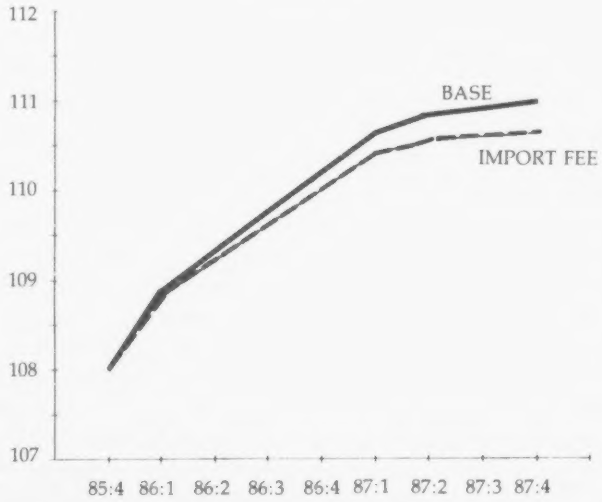
IMPACT OF A $5 PER BARREL IMPORT FEE ON GNP
(billions 82$)



Lower investment means that fewer private sector jobs will be created; civilian employment will fall by 0.1 percent and 0.3 percent in 1986 and 1987, respectively, compared to what would have been the case without the added tax (see Chart 4). As a result, the civilian unemployment rate will be 0.1 percentage points higher in 1986 and 0.2 percentage points higher in 1987.

CHART 4

IMPACT OF A $5 PER BARREL IMPORT FEE ON EMPLOYMENT
(millions)



The new tax reduces the size of the government deficit. However, the dynamic reduction ($17.9 billion over the two years), is $3 billion less than the static revenue estimate. The deficit is not reduced by as much as expected because lower levels of economic activity and higher unemployment raise federal expenditures and reduce receipts. On the other hand, the increase in inflation resulting from the tax offsets part of the reduction in government receipts.

A Weaker Dollar

With all the attention being paid to the decline in oil prices, another piece of good economic news, the depreciation of the dollar, is being ignored. A falling dollar will improve the international price competitiveness of U.S. exports, thereby reversing the trend toward ever larger trade deficits. Moreover, the combination of a falling dollar and falling oil prices mitigates the inflationary pressures which result from the change in the value of the currency.

The factors behind the dollar's slide are various. Nevertheless, media accounts credit government intervention in international exchange markets with this development. In past issues of the OUTLOOK (see the September 1983 and April 1985 issues), we analyzed the factors behind the dollar's strength during 1980/1984 and voiced our skepticism about the effectiveness of foreign exchange intervention. Although the trade-weighted value of the U.S. dollar has declined by 25 percent during the last twelve months, it is our belief that intervention had very little to do with it. As history has repeatedly shown, the currency's value would not have continued on a downward path solely due to intervention. The fact that it has continued to decline points to underlying economic fundamentals which were already nudging the dollar downward seven months prior to the Group of Five announcement.

There are several reasons for the dollar's relative weakness. As can be expected, these are the reversal of most of the trends that had argued for its strength in the past.

The decline in the dollar's value, which began in February 1985, was prompted by expectations of relatively stronger growth overseas. While the dollar was appreciating, economic growth was proceeding at significantly stronger rates in the United States relative to our trading partners. Last year, however, the economies of our major trading partners began to improve markedly, while signs of weakness were apparent in the United States. Now, although the outlook for the U.S. economy has improved, the economies of major nonoil producing countries, such as West Germany and Japan, will benefit relatively more than the U.S. Moreover, because oil is priced in dollars, these nations stand to benefit even more from the oil price decline now that their currencies are strengthening against the dollar. Improved growth abroad increases the attractiveness of investment there relative to investment in the United States. This increases the demand for other currencies and reduces the demand for dollars and thus results in the appreciations of the mark and the yen.

Relative inflation trends have also been reversed. Although inflation has been on a downward path in all the major industrial nations, U.S. inflation was decelerating at a relatively faster pace during the early 1980s. During the past year, however, the rate of growth of consumer prices has fallen more rapidly in West Germany and Japan than in the United States. For example, in West Germany, the rate of growth in consumer prices fell by 0.8 percentage points during the past twelve months, while Japanese inflation has decelerated by 0.9 percentage points. In the United States, on the other hand, there has been no significant change in the rate of inflation during the past twelve months.

This discrepancy in relative inflation rates should widen during the next two years. The appreciation of other currencies against the dollar means that inflation in those countries should decelerate as the price of imported goods falls and foreign competition in domestic markets pushes domestic producers to lower their prices in order to remain competitive. At the same time, the opposite will be happening in the United States since a lower-valued dollar implies higher prices for imported goods and services.

During the early 1980s, relatively higher real interest rates in the United States increased the attractiveness of holding dollar-denominated assets, thus raising the demand for dollars and contributing to its appreciation. This trend has now been reversed. The real interest rate differential has also moved in a direction which will tend to weaken the dollar. In March 1985, real U.S. interest rates were 0.6 percentage points higher than those in West Germany and 3.7 percentage points higher than in Japan. Today, despite the recent reductions in prime lending rates in Japan, West Germany and the United States, U.S. real interest rates are 1.2 percentage points *lower* than the West German equivalent and only 2.2 percentage points higher than the Japanese. As a result, dollar-denominated assets are losing their attractiveness while yen- and mark-denominated assets are increasing theirs. This increases the demand for yen and marks while reducing the demand for dollars, leading to the appreciation of the former currencies and the depreciation of the latter.

Finally, the large U.S. trade deficit should begin exerting downward pressure on the dollar, since a strong U.S. demand for imported goods and services means that the U.S. is supplying dollars to the world economy. However, over the past few years, this supply of dollars was not sufficient to satisfy the demand which stemmed from the very attractive rate of return of dollar-denominated assets.

But now that both inflation and interest rate considerations should place downward pressure on the dollar, our large trade deficit should help further this trend. As a result, we expect the dollar to continue to depreciate, albeit at a more moderate rate. The trade-weighted value of the dollar is anticipated to fall by 11 percent during 1986 and five percent during 1987. This decline would place this index of the dollar's value at about the level it was in 1981 when the appreciation began.

Impact of the Dollar's Depreciation

Dollar depreciation affects the national economy by changing the prices of imports and exports. That is, a lower valued dollar reduces the foreign currency value of our exports, improving their competitiveness and raising foreign demand for our goods and services. At the same time, the dollar value of imported goods rises as the dollar depreciates. The effect is to increase U.S. exports and reduce imports, thus improving our trade balance and boosting national output, income and employment. The negative side effect, of course, is increased domestic inflation as imported goods become more expensive and as foreign competition in domestic markets subsides.

This price effect depends on the magnitude of the dollar depreciation and the extent to which it is "passed through" to prices of exports and imports. Earlier last year, it had been argued that foreign suppliers would limit price increases in order to maintain the market shares that they had been able to garner during the past five years. Further, it was noted that their profit margins were sufficient to allow for this price restraint. As the dollar's value has continued to fall, and as it has become evident that the recent decline is not temporary, the price of imports has increased, in some cases, quite substantially. Imported products, from Japanese television sets, to German cars, to French wines, have all experienced price increases in the past few months. Estimates place the average "pass through" at 60 percent of an exchange rate change; that is, foreign producers have, in the past, absorbed only 40 percent of the price changes due to exchange rate fluctuations.

The increase in the overall price level resulting from the depreciation of the currency depends on monetary policy. A rise in the price level can only be accommodated by an increase in money supply, a decline in money demand, or a decrease in real output. According to a Federal Reserve study, the impact of domestic currency depreciation, assuming that the Fed accommodates a one-time increase in the price level, but not a continuing higher rate of inflation, shows that for a 10 percent depreciation, consumer prices rise by 0.75 percent in the first year and 0.75 percent spread evenly over the second and third years. But because of the lags involved between changes in the value of the currency and their impact on domestic inflation, the U.S. economy was still experiencing the effects of previous appreciation during 1985. The extent to which inflation will rise during the next two years depends on the future path of exchange rates as well as on other factors such as capacity utilization, productivity growth, wage demands, oil prices and monetary policy.

A lower valued dollar spells welcome relief for many of our nation's industries since it will improve their price competitiveness in international as well as domestic markets. As a result, U.S. exports should increase and imports decline, thereby reducing the trade deficit. However, import volumes do not respond immediately to changes in import prices; thus, the initial effect of depreciation is to raise the dollar value of imports. Research shows that, in the case of the United States, this effect is not strong enough to result in a deterioration in the trade balance, yet it is sufficient to result in significant lags between a change in the value of the currency and its impact on the trade balance. Estimates place the length of this lag at somewhere between 12 and 18 months following the initial decline in the currency's value.

Nevertheless, there are some signs of improvement in the industrial sector which can be traced to the dollar's decline. As foreign competitors begin to raise their prices, American firms are winning more orders at home as well as abroad. The industrial production data is reporting increased activity in several industries. During 1985, output in the transportation sector rose by 8.8 percent. Exports of transportation equipment rose by 10.8 percent in November 1985 compared to its year-earlier level, while the motor vehicles and parts component enjoyed an increase of 7.1 percent during the same period.

Declining Dollar and Oil Prices: A Net Plus

In the short run, concerns about sharply accelerating inflation due to the dollar's decline have been rendered moot by the offsetting effect of the decline in oil prices. This month's forecast assumes that the price of imported oil averages $14 per barrel and the dollar drops by 11 percent during 1986. Unit labor costs are expected to rise only moderately as labor productivity improves. Since the nation's productive capacity is not being fully utilized (capacity utilization stands at only 80.6 percent in the manufacturing sector), this combination of forces argues for a further deceleration in consumer price increases in 1986 (see Table I). Consumer prices are expected to rise in 1987 as oil prices stabilize at a lower level.

Real exports rose by 7.4 percent during the last quarter of 1985 following declines of 11 percent and five percent during the second and third quarters, respectively. This end-of-year improvement was not sufficient, however, to offset the continued strength in the real value of imports, which rose by 19 percent in the fourth quarter. As a result real net exports deteriorated by $14 billion during 1985's

TABLE I
UNITED STATES ECONOMIC OUTLOOK 1986-1987
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates.)

	QUARTERS									YEARS			
	Actual			Forecast						Actual		Forecast	
	85:2	85:3	85:4	86:1	86:2	86:3	86:4	87:1	87:2	1984	1985	1986	1987
GROSS NATIONAL PRODUCT													
Real GNP	1.1	3.0	1.2	3.9	4.7	6.6	7.3	5.8	4.0	6.8	2.3	4.0	5.0
Consumption	2.6	4.6	0.1	3.4	3.6	4.5	4.8	2.9	2.8	5.3	3.3	3.1	3.5
Residential Investment	7.1	8.5	6.4	18.8	19.0	4.6	-.6	-1.0	-.7	12.2	1.8	11.3	.9
Nonresidential Investment	12.5	2.4	10.0	4.5	8.0	10.0	13.1	9.2	7.6	19.8	9.6	7.6	9.6
Equipment	16.9	3.0	10.4	7.6	10.8	12.5	15.2	10.6	7.4	21.5	8.6	9.8	10.7
Structures	5.2	1.2	9.2	-1.2	2.9	5.4	9.1	6.5	8.1	15.6	11.6	3.6	7.4
Exports	-10.9	-5.1	7.4	8.2	16.2	14.3	19.1	18.4	17.6	4.7	-2.9	7.9	17.4
Real Net Exports	-101.1	-119.8	-134.0	-133.5	-124.8	-109.1	-92.6	-81.5	-68.4	-85.0	-106.7	-115.0	-62.5
Imports	18.2	12.8	18.6	5.5	4.4	-2.1	.9	5.4	3.7	27.0	2.4	7.9	3.0
Government Purchases	2.1	37.3	16.1	-16.9	-16.7	-3.4	.0	-.3	-1.2	3.5	9.8	-.9	-2.1
Final Sales	1.2	5.0	2.1	2.3	3.8	5.8	6.6	4.2	4.1	6.0	4.0	3.5	4.8
Change in Business Inventories (82$B)	15.1	-1.8	0.1	6.6	14.9	21.6	28.8	44.0	44.1	24.8	7.3	18.0	45.2
Industrial Production	2.0	3.1	1.4	8.4	7.2	11.8	13.9	9.8	6.0	10.6	2.5	6.5	9.3
New Car Sales (total, mill.)	10.9	12.4	10.3	11.0	11.7	11.7	11.7	11.4	11.8	10.4	11.1	11.5	11.8
New Domestic Car Sales (mill.)	8.2	9.4	7.0	8.0	8.3	8.3	8.9	8.5	8.2	8.0	8.9	8.4	8.1
New Housing Starts (mill.)	1.74	1.69	1.75	1.97	1.99	1.97	1.95	1.95	1.95	1.80	1.73	1.97	1.95
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	7.3	7.2	7.0	7.0	6.7	6.4	6.0	5.8	5.6	7.5	7.2	6.5	5.5
Compensation	4.1	3.7	3.7	4.9	3.1	3.2	3.5	4.8	4.3	4.2	3.9	3.7	4.1
Productivity	1.0	0.5	-1.9	.3	2.1	3.1	3.2	1.8	.9	2.7	-0.2	.8	2.0
Unit Labor Costs	3.1	3.2	5.6	4.6	1.0	.1	.3	2.9	3.4	1.4	4.1	1.5	3.3
Consumer Price Index	4.3	2.3	4.2	1.5	1.7	3.2	4.0	5.1	4.9	4.3	3.5	2.7	4.4
Implicit GNP Deflator	3.3	2.9	3.3	3.5	2.0	2.1	2.8	3.7	4.3	3.8	3.3	2.9	3.5
Prime Interest Rate (%)	10.2	9.5	9.5	9.2	8.8	8.7	8.7	8.7	8.3	12.0	9.9	8.9	8.4
3-mos. Treasury Bill Rate (%)	7.5	7.1	7.2	6.8	6.3	6.4	6.5	6.4	6.1	9.5	7.5	6.5	6.2
Corporate Bond Rate (%)	11.6	11.0	10.6	9.7	9.3	9.3	9.1	8.7	8.4	12.7	11.4	9.4	8.3
Real Personal Disposable Income	8.3	-4.6	2.5	5.0	3.2	2.7	2.9	3.8	1.5	6.7	1.5	3.4	2.1
Profits from Current Production ($B)[1]	205.8	221.7	224.2	232.0	242.0	256.0	272.0	283.0	298.0	195.9	213.0	250	304
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts										666.0	736	793	862
Unified Outlays										842.0	937	990	1015
Unified Deficit										-176.0	-201	-197	-153

[1] After-tax corporate profits with inventory valuation and capital consumption adjustments.

[2] Unified budget figures on a fiscal year basis.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

The March forecast assumes that spending cuts along the lines of the Gramm-Rudman-Hollings Act's requirement are enacted in FY 1986 and FY 1987. However, the cuts fall short of the Gramm-Rudman-Hollings deficit reduction goals. Tax increases or reform are not anticipated. The nation's money supply (M1) is assumed to grow by 8.5 percent in 1986 and 7.3 percent during 1987. The trade weighted exchange value of the dollar falls by 11 percent during 1986 and 5 percent in 1987. The price of imported oil averages $14.40 per barrel in 1986 and $15.00 in 1987. The federal minimum wage is not expected to increase.

last quarter. The improvement in U.S. exports is expected to pick up momentum during this quarter and next, however, it is not anticipated to be enough to result in a significant turnaround in net exports until mid-year. During the latter half of 1986 and 1987, the benefits of the dollar's decline and the expansion in world trade should contribute to significant improvements in our trade balance, which, in turn, should boost national output and employment.

Activity in the residential investment sector is expected to further buoy gross national product. The continuing improvement in housing affordability, in particular, the decline in mortgage interest rates, has already been reflected in sharp improvements in new housing starts. Interest rates on 30-year fixed mortgages have fallen below ten percent in some areas. As a result, following a 17.5 percent improvement in December, total new housing starts reached an annual rate of 2.1 million units in January, their highest level in almost a year. Presaging continued improvements in residential construction, building permits rose by 14 percent during the past twelve months.

Further improvements in personal income are the underpinnings for a healthy consumer sector. As the stock and bond markets continue to reach new highs, consumer wealth will keep rising. Moreover, the decline in interest rates improves the consumer's willingness to purchase durables and discretionary items usually bought on credit. It should be noted that the interest rate decline has filtered through to charges on revolving credit. Although the decline in credit card interest rates is, so far, an isolated occurrence, there are instances of interest rates as low as 14 percent, compared to the prevailing 18 percent to 21 percent rates. The decline in mortgage interest rates is likely to improve household cash flow as homeowners rush to refinance their mortgages at lower rates.

Despite this rosy assessment of the outlook, the dismal February employment data indicate that the first half of this year is not likely to come in with a bang. Unfortunately, just as the benefits of the dollar's depreciation have been a long time coming, it is also likely that the detrimental effects of the oil price decline will be initially larger than the benefits. A significant proportion of the increase in joblessness during February (see Trends in Commerce section), is attributable to layoffs in the oil industry in Texas.

A word of caution is in order regarding the February employment data. The national data were revised to include better estimates of the underground economy. In the case of the household employment data, on which the unemployment rate calculation is based, this includes improved estimates of immigration, including illegal immigrants, and emigration. The net result has been to raise the estimates for population. As a result the large increase in the unemployment rate reflects a one-time adjustment to the redefinition. The business establishment survey, on the other hand, points to continued employment gains during February.

The decline in interest rates, although not necessarily welcome by investors, significantly improves the economy's health through its impact on the federal budget deficit. Lower interest rates will spur economic growth thus expanding the tax base and increasing federal revenues. At the same time, outlays for interest charges, one of the largest, and until recently, a continuously expanding contributor to the federal debt, are reduced. The interest rate that the Treasury must pay on its three-month bills fell to 6.55 percent early this month. Thus, not only is the estimate for this year's deficit reduced, but the improvement feeds through to future years since a lower deficit means smaller-than-anticipated increases in the federal debt which, in turn, implies lower-than-anticipated outlays for interest charges on that debt.

IT'S TIME TO RESTORE PRESIDENTIAL BUDGETARY POWER

by

Cesar V. Conda and William P. Orzechowski*

The Gramm-Rudman-Hollings Act and the deficit targets it requires Congress and the President to reach is potentially the most effective spending reduction proposal ever enacted by Congress. To date, the Act has been a success. Its automatic sequestering mechanism has chopped nearly $12 billion from this year's federal budget which, in addition, lowers spending in future years by lowering the spending base for 1987. The credit markets have responded favorably, with rising bond and stock prices and lower interest rates, to the prospect of declining deficits. Wasteful and extravagant federal programs have been exposed and are now being cut.

To meet the requirements of the Act, the President submitted a budget proposal in February that makes the difficult choices necessary to cut nondefense spending. The President's major policy initiatives of program terminations, privatization, federalism, social service reforms, user fees and management reforms are realistic attempts to define the proper role of government.

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But the recent three-judge court ruling against Gramm-Rudman's automatic sequestering mechanism has eased the pressure on Congress to respond with a budget that prioritizes federal spending programs and cuts the waste and inefficiency from the bloated federal budget. As one relieved member of Congress put it, "Gramm-Rudman is now a toothless tiger." Indeed, the mere threat of indiscriminate across-the-board cuts in defense and non-exempt domestic programs was supposed to force Congress to make the hard political choices that they have so far avoided. This automatic "hammer" was designed to be a force for fiscal restraint.

Fortunately, there is now reason to believe that the Supreme Court may alter the initial negative opinion of the three judge panel. But if the panel's decision stands, the fallback mechanism throws the whole process back into the hands of Congress – where it has been for the last twelve years since the enactment of the Budget and Impoundment Control Act of 1974. Congress would have to approve the across-the-board cuts by a joint resolution which would then be sent to the President for his signature. In effect, independent action by either the House, the Senate or the President would nullify the entire Gramm-Rudman-Hollings process. If the automatic trigger fails to stand up to full judicial review, the budget process will be back to business as usual with no external restraints on congressional spending. The way to avoid this outcome is to restore some budgetary power to the Executive.

The Founding Fathers originally empowered the President to veto spending bills passed by Congress. However, the boundaries of Presidential discretion over the expenditure of funds has never been clearly defined. We know that from George Washington to Richard Nixon, the President has had the power to impound or refuse to spend money that Congress had appropriated. Moreover, Congress had no formal procedure to overturn such an action.

In the first recorded impoundment, Thomas Jefferson refused to spend $50,000 that Congress had appropriated for Navy gunboats on the Mississippi River. Early presidential impoundments were almost always routine, that is, they reflected managerial savings, or a change in conditions that required the cutback of a program. Curiously, it was Franklin Roosevelt who began the practice of policy impoundments, that is, impoundments which explicitly countered Congressional intent. During his tenure, President Roosevelt impounded half a billion dollars in public works funds. President Truman continued this practice by impounding funds for domestic spending and a supercarrier. President Eisenhower ordered cutbacks and stretch-outs in defense programs to keep the federal debt within its statutory limit. During their tenure, Presidents Kennedy and Johnson reduced projected spending by six percent and 5.4 percent, respectively, through the use of impoundments.

For the most part, Congress reluctantly accepted these impoundments and a constitutional crisis did not occur until the Nixon presidency. President Nixon pushed the boundaries of impoundment powers to their limit by exercising unfettered discretion in reducing and terminating federal programs explicitly against congressional intent. In one year alone Nixon impounded almost $18 billion in funds voted by Congress. In Congress' view, Nixon's use of impoundment overstepped the bounds of executive authority. In response, Congress moved in a diametrically opposed direction by enacting the Budget Act of 1974 which repealed the Presidential prerogative to impound funds and left him with the considerably less effective rescission and deferral authority, thereby debilitating the executive's authority over the budget process.

The President's powers to rescind and defer appropriated funds is a clumsy and ineffective form of executive budget control. As the term indicates, a deferral merely postpones spending for which funds have been appropriated. Moreover, the House or Senate may force the President to spend the money immediately despite his deferral. A rescission of appropriated funding or an outright executive refusal to spend money must be explicitly approved by Congress within 45 days. However, if Congress simply does nothing, the money must be spent as originally intended. As a consequence, President Reagan has been able to reduce federal spending by only 1.3 percent through the use of rescissions and deferrals. In fact, during the past three years, President Reagan proposed rescissions totaling $4 billion, but only $221 million, or a paltry 5.4 percent of the total, has been approved by Congress.The combination of severe limits on Presidential impoundment and the use of omnibus appropriations bills which further dilute the President's powers has been the underlying cause of the explosive growth in federal spending. Since 1974, Congress has had almost unfettered power over the purse, resulting in a federal debt larger than that accumulated by all of the Presidents from Jefferson to Nixon combined. The enactment of Gramm-Rudman-Hollings was an oblique attempt to restore some form of impoundment authority to the President. While the partial across-the-board nature of the automatic sequester limits Presidential discretion, it restores an important external check on Congress' tendency to overspend; a check that up to 1974, had existed for almost 170 years.

To put teeth back into what remains of the Gramm-Rudman-Hollings process, Congress must give greater budgetary power to the President. This can be accomplished through the use of the line-item veto or enhanced recission power. These mechanisms can be tempered to limit executive discretion but at the same time serve as an effective force for fiscal discipline. They can be coupled with the Gramm-Rudman-Hollings targets or they can be used to enforce budget resolutions that approximate those targets.

In 1983, Senators William Armstrong (R-CO) and Russell Long (D-LA) submitted a proposal that would have forced Congress to stay within its own budget resolution. It would accomplish this by requiring that appropriations spending not surpass the quarterly debt-ceiling limits set by Congress as part of the yearly budget resolution. The president would be empowered to rescind spending up to a limit of 20 percent of total appropriated funds in order to stay within the debt-ceiling limits. The Long-Armstrong proposal was tabled by a vote of 49 to 46. In today's deficit-conscious political climate, such a measure probably would enjoy even more support.

Senator Armstrong also submitted a proposal which would require Congress to vote explicitly for or against a rescission order within 45 days or risk having the funds permanently withheld. This would have strengthened the President's rescission power without infringing upon Congress's ultimate authority in spending matters. According to the American Law Division of the Library of Congress, this proposal is constitutional and conforms with recent Supreme Court doctrine on the legislative veto.

Congress should, in the very least, grant the President a limited form of line-item veto power. This power would be activated only if the spending totals in omnibus appropriations bills or continuing resolutions are estimated to breach the spending ceilings set forth in the budget resolution. If Congress keeps within the ceilings that it sets for itself, the President's line-item veto power would not come into effect. To get around this, Congress may decide not to enact a budget resolution at all, and to add an extra incentive to produce a budget resolution, the previous year's resolution levels could be used as a guide. Several variations on the line-item veto are possible: Congress could let these powers expire after two or three years; cap the total reductions in a single year; or require equal reductions between defense and nondefense spending.

Most members of Congress are sincere in their desire to meet the goals of Gramm-Rudman-Hollings. Recent economic events suggest that the Gramm-Rudman-Hollings deficit targets can be easily achieved through spending reductions alone. The continued drop in the price of imported oil will spur higher-than-expected GNP growth resulting in higher tax revenues. In addition, lower interest rates and last year's cuts in defense spending have already placed the deficit on a declining path. Both the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) forecast a 50 percent decline in the deficit by 1991, to about $100 billion, without any changes in spending or tax policies. Consequently, the magnitude of required spending reductions is smaller than had been previously estimated. But it is institutionally impossible for Congress to do the job of cutting spending alone. Meeting the Gramm-Rudman-Hollings deficit ceilings will involve some politically painful cuts in popular domestic programs. Why not share some of the direct burden with the President? He is willing, but not able. In an election year, Congress can escape some of the blame for cutting spending if it restores some form of presidential budgetary power.

Perhaps Congress can learn from history. When deficits appeared in 1931 for the first time in ten years, Congress debated the same issue of granting the President statutory impoundment authority over and beyond previous practices. At that time, Pennsylvania Senator David Reed told his colleagues, "The only way by which we will get results is by putting the power into the hands of somebody who will assume the responsibility and use it... if we are to get economies made, they have to be made by someone who has the power to make the order and stand by it. Leave it to Congress and we will fiddle around here all summer trying to satisfy every lobbyist, and we will get nowhere." This advice is just as sound and applicable today as it was in 1931.

PRESSURE FOR CHANGE IN FINANCIAL MARKETS

by
Rajni Bonnie Ohri

The market forces creating the pressure for change in the U.S. financial system continue to be strong and numerous. Unfortunately, the process by which such change will be handled from a legislative, regulatory, and judicial perspective have been further confused by recent developments.

The financial industry has already been shaken by such developments as the collapse of the private deposit insurance funds in Ohio and Maryland, the failure of several government securities dealers, a record number of bank and thrift failures, and questions about the solvency of the Federal Savings and Loan Insurance Corporation (FSLIC). This year, lawmakers can expect to grapple with continuing problems in the industry, including more questions about the adequacy of the FSLIC fund, the Federal Home Loan Bank Board's (FHLBB) resulting inability to close insolvent savings institutions, the growing strains placed on money center banks by their international debt load, and the large number of small community banks driven to the wall by difficulties in the agricultural economy.

In addition, the decision of the U.S. Supreme Court to hear the Citicorp suit concerning the validity of reciprocal regional banking agreements among states has created uncertainty about the geographical expansion of banking via interstate mergers. The geographical question has been further complicated by the recent approval of a number of nonbank banks by the Comptroller of the Currency, and functional questions have become confused by a Federal Deposit Insurance Corporation (FDIC) decision to allow state-chartered banks extensive securities underwriting powers. All these factors, plus free-market forces have served to put pressure on Congress to bring some order to this confused scenario.

First Signs of Change

Today, in what is called by many a "financial free-for-all," brokerage firms can set up shop in department stores, banks sell securities and insurance companies buy banks. At the same time, legal barriers that have kept banks from crossing state lines are slowly, yet inexorably, being eroded.

The first signs of these changes in the U.S. financial sector appeared with the Financial Institutions Deregulation and Monetary Control Act of 1980. This act generally encouraged greater competition within the banking industry, while at the same time extended the Federal Reserve's control over the money supply and subjected all commercial banks, savings and loans, savings banks and most credit unions to federal regulation. Although the 1980 Act did not specifically address the interstate banking issue, it brought important changes: As of January 1, 1981, all banks were permitted to offer interest-bearing checking and NOW accounts; ceilings on deposit interest rates were to be phased out by the end of 1985; federally chartered savings and loans and savings banks were allowed to make more consumer loans, offer credit cards and invest in commercial paper.

Over the same period, there was an explosion in services offered by financial institutions. Consequently, the need for legislative reform of the functions and regulations involving depository institutions brought about the passage of the Garn-St. Germain Depository Institutions Act of 1982. The purpose of this legislation was to revitalize the housing industry by strengthening the financial stability of home mortgage lending institutions and ensuring the availability of home mortgage loans. In effect, the 1982 Act expanded thrifts' lending powers and allowed banks and thrifts to offer money-market deposit accounts.

In spite of these changes, many of the laws governing banks remain essentially unaltered. The McFadden Act of 1927, the basic federal branch banking law, effectively prevents national banks from interstate branching by limiting them to branching only inside their home states. The Douglas Amendment to the Bank Holding Company Act of 1956 (BHCA) prohibits interstate banking through means of a bank holding company acquiring banks in another state unless the state explicitly authorizes them. Initially intended to give national banks the same branching powers as state-chartered institutions, these restrictions still remain operative in the belief that they help avoid undue concentration of banking powers and preserve local banks and credit markets.

Nonbank Banks on the Move

One of the strongest movements in the banking industry today is the expanding role of the "nonbank banks." Competition from this group has been instrumental in forcing the general move toward interstate banking, and it has been helped along by the BHCA that defines a bank as an institution that accepts demand deposits and makes commercial loans. This definition allows nonbank banks to exist and operate outside the bank regulatory framework as long as they offer only one, not both of these services. It has opened the door for financial companies like American Express, Merrill Lynch, Sears and others to offer various financial services and to establish banking units on a multistate basis.

Nonbank banks have become a major bone of contention between the bank regulatory agencies, especially between the Federal Reserve Board (FRB) and the Comptroller of the Currency. In addition to receiving chartering authority from the Comptroller, the bank holding companies must also receive Fed authority to acquire the limited service banks. The FRB essentially opposes nonbank banks because it is concerned that the proliferation of such institutions undermines the BHCA's limitations on interstate banking and the separation of banking and commerce. In a January 22 decision, the U.S. Supreme Court ruled that the FRB had overstepped its authority when it tried to stop the formation of nonbank banks by redefining the term "bank" under the BHCA (FRB vs. Dimension Corporation). In response to the court decision, the FRB has put considerable pressure on members of Congress to adopt legislation that alters the statutory definition of the term "bank" under the BHCA. The House Banking Committee has already approved legislation (H.R. 20) that would close the nonbank bank loophole by redefining the term "bank" to include any institution insured by the FDIC, and grandfathers institutions that had acquired nonbank banks on or before May 9, 1984.

According to a survey by the *American Banker*, about 60 nonbanking companies operate 65 banks, and more are coming on line. Their parent companies, for the most part, are already in the financial services field: Beneficial Corporation, T. Rowe Price, Merrill Lynch, Prudential

Bache Securities. Companies such as 3-M and Ford also operate some form of bank. Sears, through its financial services subsidiary, Dean Witter Reynolds, has acquired several banks, including Greenwood Trust Company of Delaware and Sears Savings Bank (a $6.1 billion thrift in California), and operates over 300 financial service centers in Sears stores. The company is now on the verge of releasing the Discover card, designed to compete with Visa and Mastercard.

Interstate Banking Gains Momentum

Recent decisions in the courts and in Congress are also clearing the way for interstate banking. In June 1985, the Supreme Court upheld the right of states (under the Douglas Amendment to the BHCA) to agree to interstate bank mergers among themselves through regional compacts. In addition, the House Banking Committee approved legislation (H.R. 2707) that would lead to nationwide interstate banking. Treasury Secretary James Baker has also endorsed the House interstate banking bill, reaffirming the Reagan Administration's support for nationwide interstate banking. But, even as the momentum toward interstate banking grows, there is still no clear consensus among legislators, regulators, or even bankers on how to ensure that interstate banking will maintain a safe, efficient and competitive banking system.

The development of regional banking compacts, which empower banks from states of a defined region to acquire or establish banks in other states within the region, is causing concern among legislators and trade associations. Major banking trade groups, such as the American Bankers Association, although endorsing the concept of regional interstate banking, oppose the idea of including a national "trigger" provision. (A national trigger is a specific date by which nationwide banking would be required among states that had already approved regional interstate banking compacts). This provision is included in H. R. 2707, which mandates interstate banking on July 1, 1990 among all states that had approved regional interstate banking arrangements at least two years prior to that date.

Debate has also been growing over the issue of regional versus full interstate banking. Proponents of regional banking (and no trigger date) contend that while the development of strong regional banks capable of competing with huge money center banks should be encouraged, full interstate banking would lead to a banking oligopoly, the domination of the national market by a few banks. Others contend that full interstate banking is essential if banks are to meet the fierce competition of national non-banking firms such as Sears. They regard the regional banking concept as just another means for constructing artificial geographic barriers to entry which foster local and regional monopolies.

At the heart of this debate is the issue which led to the prohibition of interstate banking in the first place—will the authorization of interstate banking lead to increased concentration and decreased competition in banking? Many trade associations, such as the Independent Bankers Association of America, believe that greater concentration of financial resources at the national level will result, and are thus opposed to interstate banking in general. However, others contend that it is important to recognize that increased national concentration does not necessarily imply reduced competition at the local market level. Indeed, the elimination of geographical barriers to entry should result in more competition, greater efficiency, and more diversified services in the market.

Although the House has moved forward on these issues, Senate Banking Committee Chairman Jake Garn (R-Utah) has yet to introduce legislation addressing either nonbank banks or interstate banking. He does plan to introduce comprehensive financial reform legislation, similar to S. 2851, a bill approved by the Senate last year but killed by the House committee. The financial reform bill, S. 2851, would have closed the nonbank bank loophole with a July 1, 1983 grandfather date and would have authorized regional interstate banking agreements with no national "trigger."

Federal Deposit Insurance Reform

Another motivating factor in moving toward interstate banking has been the recent failure of many thrift institutions and a desire to remedy these failures as inexpensively as possible. One way to accomplish this is to allow outside banks to buy the failing institutions.

Currently, Congress and the regulators are studying two major problems inherent in the deposit insurance system: difficulties of operating the system as a whole, and perceived inequities affecting insured institutions. As it is presently structured, the federal deposit insurance system is thought to encourage greater risk-taking among some of the institutions it insures. This situation arises primarily because of two factors. First, all institutions are treated alike for purposes of insurance coverage and premiums, even if their risk characteristics differ. Thus, the federal deposit insurance system arguably does not provide sufficient direct incentives to discourage excessive risk-taking by insured financial institutions. Second, because of the way failures of most depository institutions have been handled in the past several years, most depositors have been made whole even if their funds on deposit have exceeded the explicit insurance coverage. In this case, the insurance system provides few incentives for depositors to assess the financial conditions of the institutions in which they place their funds.

The FHLBB has advanced legislation (H.R. 1680 and S. 759) to revamp the thrift insurance structure by requiring those thrifts which engage in activities that the agency considers risky to pay higher insurance premiums and to impose higher premiums on S&Ls with low net worth levels. That legislation and another bill submitted by the agency (H.R. 2444 and S. 1167) would also give the agency stronger supervisory powers, enable the FHLBB to prohibit certain activities, establish a "thriftness" test that requires federally insured institutions to keep a major portion of their portfolios in home mortgage loans, and make further changes in thrift laws. However, the FHLBB's legislation does not reach the heart of the FSLIC's problem, namely its lack of funds. The Bank Board has yet to suggest a clear plan for injecting more money into the fund or some method of taking care of the insolvent S&Ls.

High on the list of possible solutions to the FSLIC's problems is to encourage nondepository institutions to acquire problem thrifts. This technique would inject new management and capital into the thrift industry and would reduce the FSLIC's problems by allowing it to dispose of problem institutions without spending an excessive amount of funds. Commercial companies, such as automobile manufacturers and insurance companies, already may acquire thrifts under the Unitary Savings and Loan Holding Company Act, but in practice, the FHLBB has discouraged some types of commercial acquirers, especially securities firms.

Alternatively, the Treasury Department has suggested tapping the equity of the FHLBB and providing some type of stand-by line of credit such as that approved for the Farm Credit Administration. (The new law authorizes Treasury to inject funds into the Farm Credit System, subject to authorization of the assistance by Congress, if the system's capital and reserve resources are exhausted. It also mandates resource sharing within the system.) The U.S. League of Savings Institutions supports the idea that the FHLBB resources should be available to help with the FSLIC's problems. The National Council of Savings Institutions favors the idea of allowing nondepository institutions to acquire problem thrifts. If the FSLIC fund faces a financial emergency that does not allow one of these alternatives to be put into place, Congress may consider the idea of merging the FSLIC with the much larger FDIC insurance fund, a remedy that is strongly opposed by both the banking and thrift industries.

Securities Activities of Banks

High on the list of pressures prompting the deregulation debate further is the increase in securities activities of banks and bank holding companies. "Securitization" – the growing preference of corporations to borrow from the public instead of from the banks – has eroded the distinction between loans and securities, and diminished the commercial lending opportunities available to banks. In response, the banks are rapidly trying to chip away at 50 years of legislative separation between commercial banks, which previously concentrated on taking deposits and granting loans, and investment banks, which primarily engaged in the underwriting, trading and sale of securities. With few exceptions, the two arms of finance have been legally separated since the Glass-Steagall Act was passed.

The Glass-Steagall Act of 1933 stipulates that commercial banks may only underwrite general obligation bonds of state and local governments and, through their trust departments, may purchase and sell stock and securities. Specifically excluded, however, is the underwriting and dealing of corporate long-term debt and stocks by commercial banks directly, or in the case of Federal Reserve member banks, through affiliates. The Act has also prevented securities firms from encroaching on markets served by commercial banks. These restrictions, however, do not exclude banks from engaging in all securities activities. U.S. commercial banks are expressly authorized to underwrite and deal in U.S. government securities and those securities that are the general obligations of states and municipalities. Moreover, a number of foreign banks – those grandfathered under the International Banking Act of 1978 – can engage in both investment and commercial banking in the U.S. And, in foreign markets, U.S. commercial banks can underwrite and deal in corporate and other types of securities through offshore affiliates or subsidiaries.

In the debate regarding the issue of separating commercial banking from investment banking, several potential conflicts of interest have been identified. Glass-Steagall opponents argue that depository institutions are not significantly different from other providers of financial services, such as securities brokers, investment bankers and insurance companies. Each offers products or services that complement or are substitutable for each other. Proponents of deregulation hold that any barriers preventing financial firms from entering each other's businesses should be dismantled, enabling all financial firms to compete on a 'level playing field.' They contend that the Act's only function is to protect investment bankers from competition, thereby reducing the efficiency of the capital markets, harming both savers and investors. In addition, to prevent possible abuses, bankers feel it is not necessary to separate investment and commercial banking since other laws and regulations provide adequate protection against abuses.

On the other hand, those who favor Glass-Steagall's retention argue that banks should be distinguished from other financial and nonfinancial providers and that the government, through the regulatory agencies, should assure their safety and soundness. The Securities Industry Association, in particular, contends that the elimination of the Act would result in inadequate customer protection, increased concentration of financial powers, and a movement toward European-style universal banking with its bias against entrepreneurship. In addition, Glass-Steagall proponents allege that because banks possess advantages such as entry restrictions, deposit insurance, and access to the FRB's discount window, they would have a competitive advantage over other suppliers of financial services unless reciprocal entry is allowed.

The current prospects for the abolition of the Glass-Steagall Act are unclear. In recent sessions of Congress, numerous draft bills have been debated. These bills have incorporated provisions allowing banks to offer open-ended mutual funds and to underwrite both municipal revenue bonds and mortgage-backed securities (S. 2851), proposals which represent significant modification of Glass-Steagall. However, no serious proposal has been made to allow banks into domestic corporate securities underwriting, despite the apparent success of large U.S. banks in underwriting corporate (dollar-denominated) Eurobonds.

The latest development in the legal battle between the banking industry and the securities industry involves the incursion of Bankers Trust into the lucrative commercial paper market (short-term corporate debt used to finance seasonal and other short-term operating needs), an area traditionally reserved for securities firms. A recent federal court decision, however, ruled that Bankers Trusts' commercial paper operation was not permitted under the Glass-Steagall Act as it posed potential conflicts of interest that could provide a financial incentive to distort lending practices. Several other banks, including Chemical and Bank of America, also have commercial paper operations, but have no plans to suspend them. The FRB has not yet decided whether it would take action to prevent banks from underwriting commercial paper.

In addition, last summer the Securities and Exchange Commission (SEC) ruled that banks offering brokerage services must conform with SEC requirements, implying that banks will have to register with the SEC, meet capital requirements and set up separate brokerage subsidiaries in order to continue to offer securities. The American Bankers Association predicts that many of the 2,000 banks providing brokerage services will discontinue rather than pay the extra costs involved in meeting the SEC's demands.

Conclusion

As has been the case for the past three years, state legislators, the regulatory agencies, and the courts are likely to be more active in setting the rules for the financial industry than Congress. However, there are a few issues that Congress will be forced to resolve in 1986. Titles I and II of the 1982 Garn-St. Germain Act will expire April 15, and Congress must decide whether to extend them. These provisions authorize the FHLBB to issue net worth certificates to savings institutions with low net worth and give both the Bank Board and the FDIC power to arrange emergency interstate and interindustry mergers of failing institutions. The 1982 law gives the FDIC and FHLBB authority to seek merger partners across state and industry lines for failed institutions with more than $500 million in assets. The FDIC has asked Congress to lower that threshold to about $200 million or to allow the agency to use the emergency authority for any of the 10 largest banks in any states.

Everyone seems to agree on one thing: any legislative action will redefine the term "bank" and close the nonbank bank loophole. Existing institutions would be grandfathered, leaving a number of nonbank banks in business. Although Senate Banking Chairman Jake Garn agrees with House Banking Chairman Ferdinand St. Germain that the nonbank bank loophole should be closed, he refuses to accept single-purpose, loophole-closing legislation. Garn believes that banking organizations should be able to offer a broader range of financial service products, whereas St. Germain maintains that a re-regulation course would better serve the consumer.

TRENDS IN COMMERCE NOTES ON TABLE II MARCH 1986

by
Martin Lefkowitz *

Gross National Product (GNP)—The Department of Commerce's revised estimate of Gross National Product—the value of the output of goods and services—shows that the inflation-adjusted growth rate for the fourth quarter was 1.2 percent, half the pace previously estimated. Real GNP growth over the four quarters of 1985 was 2.3 percent, a substantial drop from 1984. The fourth quarter revision reflected a sharp deterioration in the nation's trade deficit and lower inventory investment. The plunge in new car sales during the fourth quarter resulted in a 0.1 percent decline in consumer spending compared to an increase of 4.6 percent in the third quarter. On the other hand, business inventories, business fixed investment, and government purchases rose substantially. Real business investment rose at a ten percent annual rate.

The Services Sector—Employment in service sector establishments jumped 294,000 in February and is now

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three million above its year-ago level. This compares with an increase of 187,000 jobs in the goods-producing sector over the last year. Over 94 percent of the job growth in the economy during the past year has been in services industries.

Consumer purchases of services dropped 0.3 percent in January as consumers responded to a 0.1 percent drop in income. Major domestic airlines reported that revenue passenger miles flown, that is, the number of passengers multiplied by the miles flown by each passenger, reached 19.8 billion in January, an increase of 10 percent from its year-ago level. For 1985 as a whole, major U.S. carriers reported an 11.3 percent increase in revenue passenger miles flown compared to 1984.

Money Supply—The nation's money supply—as measured by M-1, currency in circulation plus demand deposits—increased by 0.1 percent during January, virtually unchanged from the previous month. Money supply growth has slowed to an 8.3 percent annual rate in the latest three-month period, but is still 11.4 percent above its year-ago level, and remains considerably above the Fed's target range.

Employment—Civilian employment—as measured by the monthly survey of households—decreased by 394,000 in February.The civilian unemployment rate increased 0.6 percentage points in February to 7.3 percent. Almost two-thirds of the rise in unemployment was registered in three states—California, Texas and Illinois, whose performance reflects the impact of bad weather and falling oil prices. A quarter of the rise in unemployment was concentrated among Hispanics and in the farm sector. The number of nonagricultural payroll jobs—as measured by the monthly survey of business establishments—increased by 225,000 in February.

Prices—The Consumer Price Index for all urban consumers (CPI-U) increased 0.3 percent in January, the smallest monthly increase since September. This places the index 3.9 percent above its year-ago level. The slower inflation pace was mainly the result of smaller increases in the energy and food components. With oil prices continuing to drop sharply, experts predict that the February index should show no increase at all at the retail level.

Wholesale prices of finished goods decreased 1.6 percent from January to February and are 0.1 percent lower than their year-ago level. This was the largest one-month decrease since 1947. The major contributing factors were a 9.6 percent drop in finished energy goods and a 1.6 percent drop in food prices.

Crude goods prices fell 5.0 percent in February, following a 1.4 percent decrease in crude goods prices during January. The February fall was the largest monthly decline since September 1973. February crude material prices were 8.7 percent below their level of a year ago. All major categories, except construction materials, are below their 1985 levels. Crude energy materials fell 8.2 percent, foodstuffs and feedstuffs declined 3.6 percent, and other raw materials were down 3.0 percent.

Housing Starts—Privately owned housing units were started at a seasonally adjusted annual rate of 2,088,000 in January, an increase of 15.7 percent from the December level. The January figure was the highest since February 1984 and was 15.7 percent above its year-ago level. Most of the improvement in starts is attributable to steady declines in mortgage interest rates as both fixed and adjustable rate mortgages have fallen by about 1.5 percentage points over the past year. Building permits, an indicator of future activity in the home building industry, were virtually unchanged on a month-to-month basis, but were 14 percent higher than their year-ago level.

Industrial Production—Industrial production decreased by 0.6 percent in February, following a 0.7 percent jump in December, and was 2.5 percent above its year-ago level.

The capacity utilization rate in manufacturing increased to 80.6 percent in January from 80.5 percent in December. The increase occurred in motor vehicles and parts (2.8 percentage points) and petroleum products (4.5 percentage points). Manufacturing capacity rose 0.6 percent in the third quarter of 1985, up three percent from a year ago.

Productivity—Nonfarm business productivity fell 0.2 percent during 1985, the first annual decline since 1982. Business output rose 2.7 percent while hours worked increased 2.8 percent for the year as a whole. Manufacturing productivity rose 2.7 percent in 1985 and output in the manufacturing sector rose by 2.5 percent, while hours worked were down by 0.2 percent.

Interest Rates—After nine months at 9.5 percent, the prime interest rate fell to 9.0 percent on March 7th, 1.5 percentage points below the rate prevailing at this time last year. The prime lending rate is now at the lowest it has been since August 1978. Three- and six-month Treasury bill rates were both below seven percent in early March, and thirty-year Treasury bond rates dropped to nearly 8.0 percent, the lowest level in over eight years.

Business Failures and Formations—Dun and Bradstreet's Index of Business Failure indicates that business bankruptcies in 1985 were up by 6.4 percent as compared to 1984.

Dun and Bradstreet reported that 607,244 new business corporations were formed in the first eleven months of 1985, an increase of 4.3 percent from the same period in 1984. At the present rate, there will be over 660,000 new corporations formed in 1985 compared to 634,991 in 1984.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Nov/85	240.1	239.9	237.9	0.1	0.9
Gross National Product ($B)	IV/85	4,061.1	4,016.9	3,825.5	1.1	6.2
Gross National Product (82$B)	IV/85	3,594.8	3,584.1	3,515.6	0.3	2.3
Money Supply (M1) ($B)	Jan/86	626.9	626.3	562.9	0.1	11.4
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Jan/86	2,667.0	2,677.6	2,510.3	−0.4	6.2
Personal Consumption Expenditures (82$B)	Dec/85	2,359.1	2,318.3	2,278.7	1.8	3.5
Disposable Personal Income ($B)	Jan/86	2,878.6	2,873.2	2,748.6	0.2	4.7
Disposable Personal Income (82$)	Dec/85	2,531.5	2,509.5	2,492.0	0.9	1.6
Personal Savings Rate (%)	Jan/86	4.0	3.4	5.7	0.6[b]	−1.7[b]
Civilian Employment (millions)	Feb/86	108.6	109.0	106.6	−0.4[c]	1.9[c]
Civilian Unemployment Rate (%)	Feb/86	7.3	6.7	7.3	0.6[b]	0.0[b]
Average Hourly Earnings	Feb/86	$8.72	$8.68	$8.49	0.5	2.7
Consumer Price Index (All Urban, 67 = 100) [a]	Jan/86	328.4	327.4	316.1	0.3	3.9
Purchasing Power of the Dollar (67 = $1.00) [a]	Jan/86	0.305	0.305	0.316	0.0	−3.5
Prime Interest Rate (%) March 7, 1986		9.0	9.5	10.5	−0.5[b]	−1.5[b]
Retail Sales ($)	Feb/86	117.3	117.4	112.1	−0.1	4.6
SERVICES SECTOR						
Employment in Services (Millions)	Feb/86	75.5	74.2	71.5	1.8	5.6
Consumer Purchases of Service ($B)	Jan/86	1,360.4	1,364.3	1,271.5	−0.3	7.0
Consumer Purchases of Service (82$B)	Dec/85	1,146.3	1,130.7	1,112.9	1.4	3.0
Domestic Revenue Passenger Mileage Flown Major Airlines (Billions) [a]	Jan/86	19.8	21.1	18.0	−6.2	10.0
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B) [a]						
Before Tax [a]	III/85	228.6	218.7	227.7	4.5	0.4
After Tax [a]	III/85	141.1	136.4	140.3	3.4	0.6
Industrial Production (77 = 100)	Feb/86	125.7	126.5	123.7	−0.6	1.6
Capacity Utilization Rate (Mfg.) (%)	Jan/86	80.6	80.5	80.7	0.1[b]	−0.1[b]
New Housing Starts (thou. units)	Jan/86	2,088.0	1,804.0	1,804.0	15.7	15.7
Net Business Formation (67 = 100) [a]	Jan/86	117.8	119.5	115.9	−1.4	−1.6
New Business Incorporations (Thousands)	Nov/85	54.8	57.6	53.5	−4.9	2.4
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	IV/85	170.5	167.8	163.9	1.6	4.0
Unit Nonlabor Costs (nonfarm) (77 = 100)	IV/85	158.0	161.4	158.4	−2.1	−0.3
Producer Price Indices (67 = 100)						
Crude Materials	Feb/86	290.5	301.3	318.9	−5.0	8.7
Intermediate Goods	Feb/86	313.5	319.5	319.5	−1.4	−1.6
Finished Goods	Feb/86	292.3	296.2	292.1	−1.6	0.1
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100)	Jan/86	616.7	640.2	572.0	−3.7	7.8
Federal Government Debt Outstanding ($B) [a]	Sep/85	1,827.4	1,822.4	1,576.7	0.3	15.9
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	IV/85	368.7	363.2	389.5	1.5	−5.3
Imports of Goods & Services ($B)	IV/85	475.7	451.0	461.7	5.5	3.0
Balance on Goods & Services ($B)	IV/85	−106.9	−87.8	−72.2	21.8	48.1
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	Jan/86	173.0	174.0	166.3	−0.6	4.0

NOTES: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted

[b] Percentage point difference

[c] January data is a new series that is not comparable to previous data

Federal Spending–The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, increased by 7.8 percent in January compared to its year-ago level. Federal receipts for the first four months of the fiscal year increased by 7.3 percent, while expenditures for the same period rose by 6.8 percent. The federal deficit for the first four months of fiscal year 1986 was $82.8 billion compared to $78.8 billion during the same period in fiscal year 1985.

Personal Savings–In January, the personal savings rate was 4.0 percent of after-tax income, an improvement from the 3.4 percent rate reached in December. Personal savings were $114.1 billion in January, compared to $99.3 billion in December. For 1985 as a whole, savings as a percent of disposable income averaged 4.6 percent, the lowest rate since the Depression Era.

Retail Sales–Retail sales declined 0.1 percent in February following a revised 0.2 percent decline in January. Sales were up 4.6 percent from their year-ago level. Most of the February decline was due to lower gasoline prices. During February, department, furniture and home equipment stores continued to register strong gains. Durable goods sales were virtually unchanged compared to January, but were 7.6 percent above their February 1985 level. February nondurable goods showed no change from the January level, but were 2.9 percent above their year-ago level.

Trade Deficit–The 1985 merchandise trade deficit reached $148.5 billion. On a monthly basis, the January merchandise trade deficit reached a record $16.5 billion, which followed a new record set in December. About one-third of the increase in 1985's merchandise trade deficit was attributable to a lower level of exports, and two-thirds of the increase was due to a higher level of imports. On a goods and services basis, it averaged $107 billion in the fourth quarter, significantly above the $88 billion reported in the third quarter. In 1985, the trade deficit on a goods and services basis was $76.9 billion, an increase of $17.7 billion from 1984. In 1985, imports rose six percent, on a current dollar basis, from their year-ago level while exports fell 2.2 percent.

What's Ahead–The composite index of leading indicators, designed to predict future movements in aggregate economic activity, fell 0.6 percent in January, the first monthly decline since April 1985. The major contributors to the January decrease were contracts and orders for plant and equipment and change in credit demand. The decline in the indicators was not a decisive move since five of 11 indicators were up five were down and one was unchanged.

DEPARTMENT OF LABOR REPORTS EMPLOYMENT AND EARNINGS CHARACTERISTICS OF FAMILIES

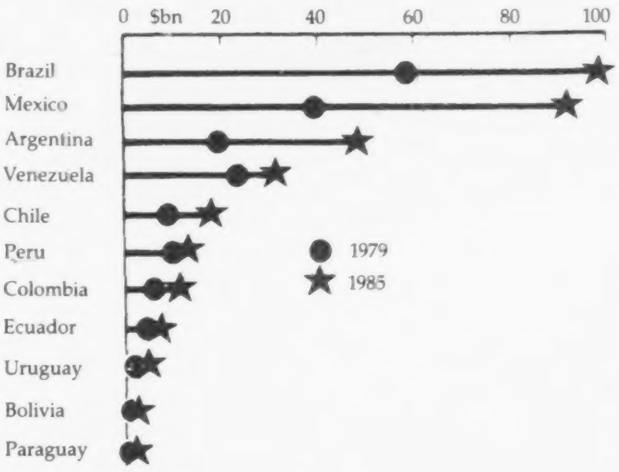
The U.S. Department of Labor's Bureau of Labor Statistics reported that nearly 60 percent of mothers in families with children under 18 were employed during the fourth quarter of 1985. While the total number of families with school or preschool children rose by 460,000 over the year, the number with employed mothers increased by 765,000 to 18.2 million.

The total number of families with employed members grew by nearly 600,000 over the year to 50.8 million–81 percent of all families. The number of married-couple families with one employed member increased by 300,000 from a year earlier to 42.1 million. The number of families with unemployed members was virtually unchanged over the year at 5.9 million. Nearly 80 percent of the married-couple families with an unemployed member contained an employed member.

LATIN AMERICAN DEBT

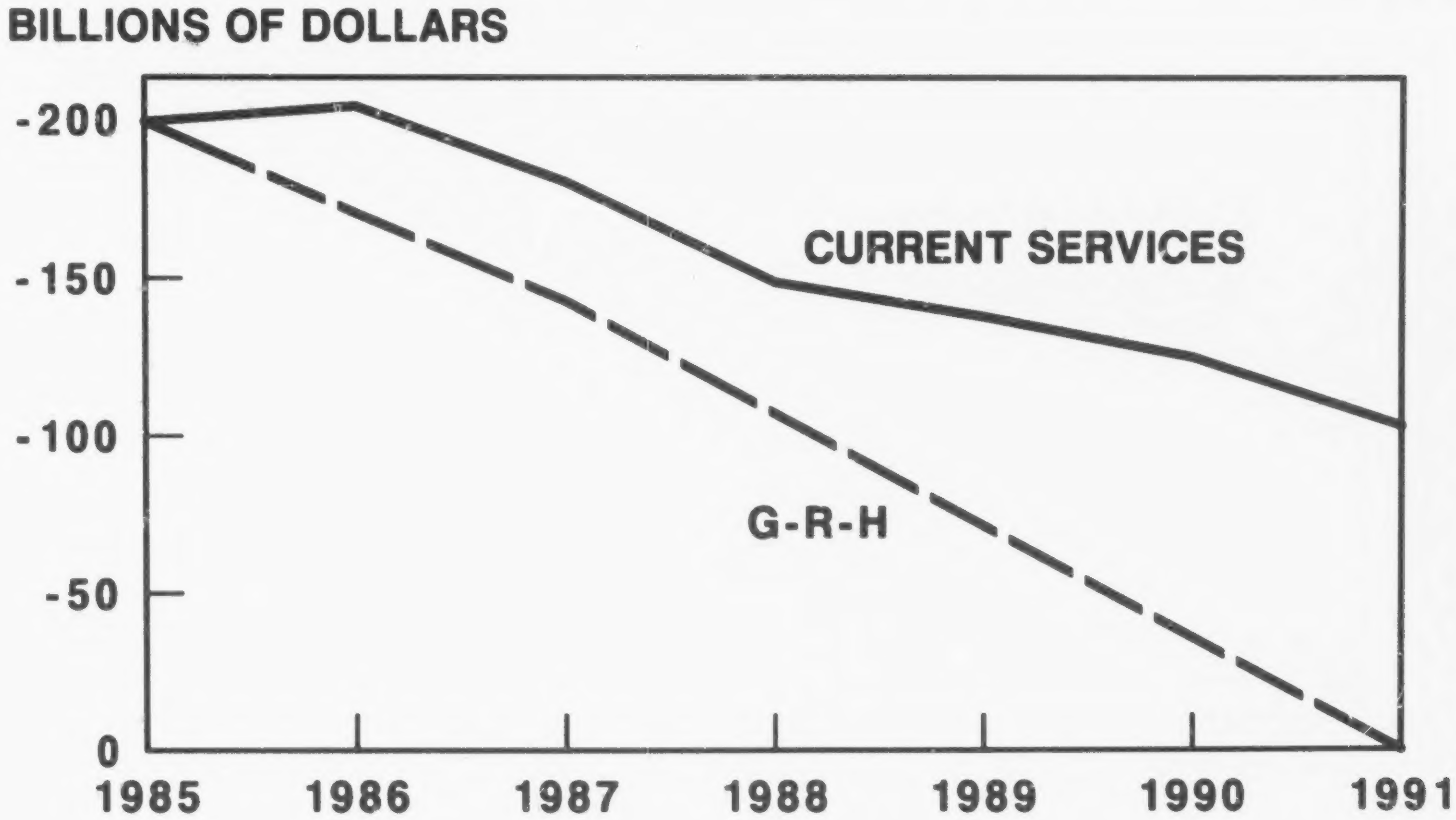
Between 1979 and 1985, Latin American debt has doubled rising from $182 billion to $368 billion. Mexico and Brazil, the two largest debtors, owe $200 billion combined, more than half of the region's outstanding debt. Over the past six years, Mexico's debt has risen by 145 percent, from $40 billion to $98 billion. The amount of debt owed by Brazil increased half as much in percentage terms as that of Mexico, rising from $59 billion to $102 billion. Argentina falls next in line; its debt increased from $19 billion to $50 billion. Venezuela's debt increased from $23 billion to $30 billion.

TOTAL EXTERNAL DEBT
($ billions)

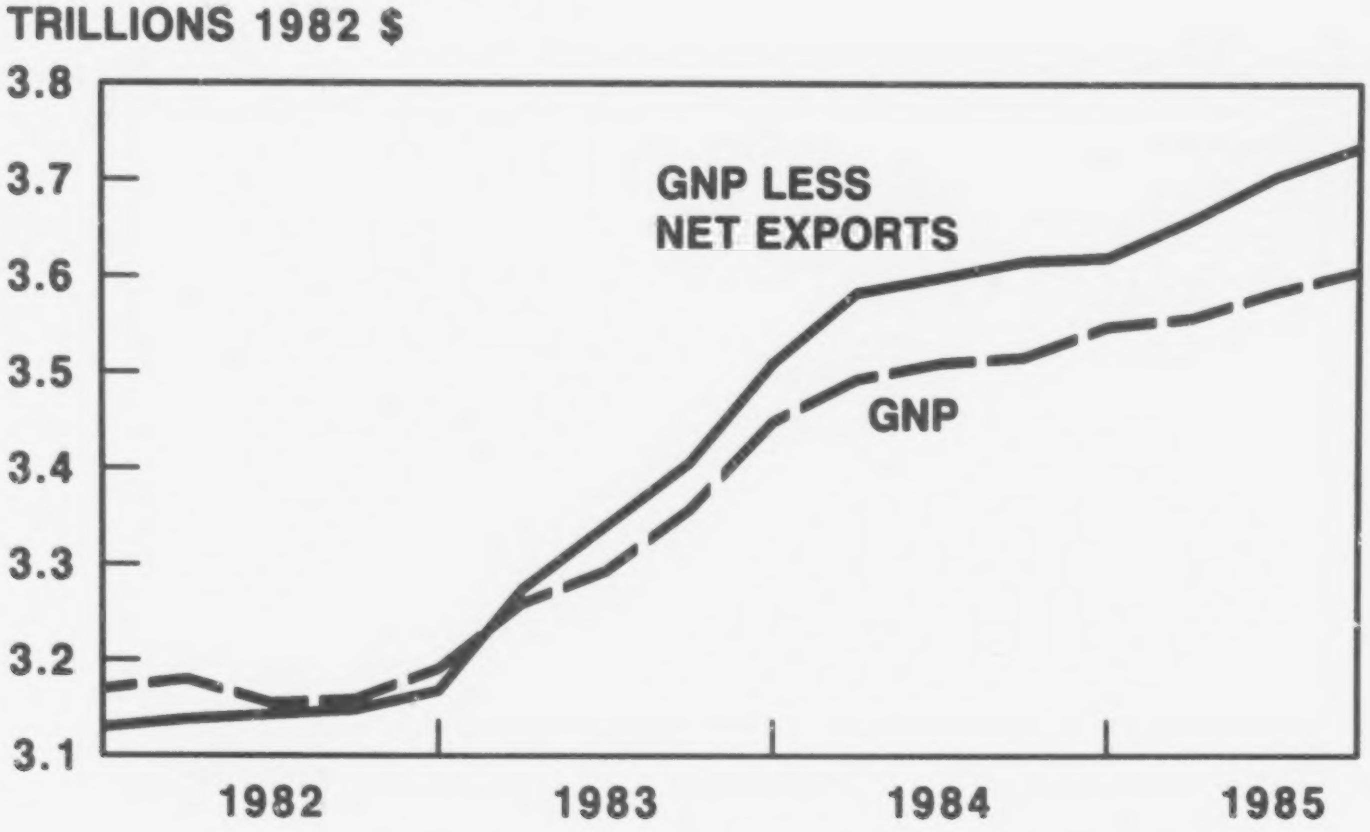


Source: The Economist, February 15, 1985

CURRENT SERVICES DEFICIT VS. GRAMM-RUDMAN-HOLLINGS GOALS



GNP MINUS NET EXPORTS



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ECONOMIC OUTLOOK

Chamber of Commerce of the United States April/May 1986

GOOD TIMES AHEAD FOR THE WORLD ECONOMY AND U.S. TRADE

by
Graciela Testa-Ortiz and Richard W. Rahn

The dollar's fourteen-month slide, lower oil prices, and improvements in economic activity in our major trading partners have finally been reflected in the GNP data. The Department of Commerce preliminary estimates of real economic activity during the first quarter of 1986 show an inflation-adjusted improvement in net exports of $14.8 billion which came about as a result of a significant rise in exports, as well as a drop in imports. During the first quarter, real exports rose by $10.2 billion while real imports declined by $4.6 billion.

The first quarter data also shows that inflation, as measured by the implicit deflator for gross national product, decelerated markedly, from a 3.3 percent growth rate in the fourth quarter of last year to 2.5 percent during the first three months of 1986. As anticipated, lower inflation and interest rates have buoyed consumer sentiment, leading to a $24.4 billion real increase in personal consumption expenditures, compared to an increase of only $0.8 billion in the previous quarter. Continued declines in mortgage interest rates have maintained the level of new housing starts at about two million units, resulting in a 9.7 percent improvement in real residential investment during the first quarter. Also contributing to the first quarter's strength was an inflation-adjusted swing in inventories of $32.3 billion.

The nonresidential investment sector, on the other hand, continues to suffer from uncertainty engendered by the tax reform debate and the initial negative impact of lower oil prices. Significant reductions in investment and employment in the domestic oil and oil-related industries have resulted in a 13.6 percent drop in nonresidential fixed investment and a 0.1 percentage point increase in the civilian unemployment rate during the first quarter of this year.

Despite the weakness in business fixed investment, the first quarter results are a first indication of a strong year ahead. Lower interest rates and prospects of a further deceleration in inflation continue to support a healthy growth path for real consumption. Housing starts will continue to benefit from declining mortgage rates and, as a result, residential investment will remain an important contributor to real GNP growth in 1986. Nonresidential investment, however, will continue weak. The latest Department of Commerce survey of business capital spending plans shows that business expects to increase nominal expenditures for new plant and equipment by only 2.3 percent in 1986 compared to a nine percent rise in 1985. Real plant and equipment expenditures are anticipated to rise by only 0.9 percent in 1986 because of the uncertainty caused by the tax reform legislation before the Congress.

The improvements that we have so far seen in the trade sector are only the beginning. Lower oil prices, inflation and interest rates have so enhanced the outlook for the U.S. as well as the world economy, that international trade will rise substantially in 1986. As a result, foreign demand for U.S. goods will increase. Moreover, the decline in the dollar's value, which is expected to continue through 1987, will enhance the competitiveness of American goods and services in domestic as well as international markets. After years of being a drag on the economy, the trade sector is expected to be a major contributor to domestic growth this year and next.

IN THIS ISSUE

Good Times Ahead for the World Economy and U.S. Trade .... p. 1
Forecast Table .... p. 6
Protectionist Pressures Continue to Rise .... p. 7
Tanks or Toasters .... p. 11
Does the Value-Added Tax Contribute to Increased Government Spending and Taxation? .... p. 12
Trends in Commerce .... p. 16

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Given preliminary estimates of first quarter performance, real GNP is expected to rise by 3.5 percent in 1986 on a year-over-year basis. The stimulus from lower oil prices, lower interest rates, and a declining dollar will gather momentum toward the end of the year, resulting in an increase in real economic activity in the five percent range on a fourth-quarter to fourth-quarter basis.

Factors Affecting U.S. Trade: Foreign Demand

The importance of the foreign sector to economic output in the United States should not be underestimated. Exports and imports have risen significantly as a share of GNP during the past twenty years, from 7.3 percent in 1965 to 15 percent in 1985. Our major trading partners are the industrial nations, which accounted for 63.2 percent of total U.S. exports of manufactures in 1984, up from 53.8 percent as recently as 1981. Similarly, 71 percent of U.S. imports of manufactures came from the developed countries. The bulk of that trade occurs with Canada, Japan and the European Community. Clearly then, improved economic growth in the industrial nations, and with it increased demand for U.S. goods and services, are indispensable if the U.S. trade gap is to be narrowed. The following section discusses the recent performance of our major trading partners and the outlook for 1986.

Economic activity slowed markedly in the industrial nations during 1985, decelerating to a 2.6 percent increase compared to a 4.7 percent improvement in 1984. The bulk of the weakness stemmed from the U.S. performance, although, with the exception of Great Britain, real GNP growth decelerated in all other industrial countries as well. In 1985, inflation in most major countries continued to rise at approximately the same rate as in 1984. The exceptions were France and Italy which enjoyed substantial declines in consumer price increases last year. Unemployment remained high in Europe, averaging 11 percent of the labor force, compared to 7.2 percent in the United States and 2.3 percent in Japan.

The falloff in world oil prices is the major development affecting near term prospects for industrial country growth. Estimates by Morgan Guaranty Trust Company show that a $10 per barrel decline in the price of oil will generate savings of $46.4 billion on the net oil import bill of the major industrial nations (the U.S., Canada, Japan, West Germany, France, the U.K., and Italy). The Morgan Guaranty analysis of the partial impact of this decline in the price of oil shows that this development *alone* will raise 1986 real GNP in the major industrial nations by 0.8 percent of the 1985 level. The study also shows that consumer prices could decline by two percentage points (see Table 1). However, these estimates exclude the effects of changes in exchange rates and government policy which could result from the drop in oil prices, as well as the wealth effects stemming from increases in the value of financial assets and the feedback effects resulting from increased world trade. If these secondary effects were included, the impact on industrial country real GNP would be stronger, and the effect on Canada and the United Kingdom would change from declines in economic activity to improvements.

TABLE 1

IMPACT OF LOWER OIL PRICES[1]

	On Real GNP[2]	On Consumer Prices[3]
United States	0.6	−2.0
Canada	−0.5	−1.6
Japan	1.5	−1.7
West Germany	1.5	−1.9
France	1.4	−1.9
United Kingdom	−1.4	−1.8
Italy	2.3	−1.8
Group Average	0.8	−1.9

(1) Assumes 1986 oil prices average $17 per barrel, down from $27 in 1985.

(2) As a percent of 1985 GNP.

(3) Percentage points.

Source: "World Financial Markets," Morgan Guaranty Trust Company of New York, March 1986.

West Germany

The German economy, already in its fourth year of a modest expansion, seems poised for further improvement. While capacity utilization is close to the 1979-80 peak, the outlook has improved significantly because the economy is close to price stability, in contrast to the accelerating inflation that characterized the situation in 1980. As of February of this year, consumer prices had risen by only 0.7 percent from their year-earlier level. The German labor market, which remained depressed despite improving economic performance, has recently enjoyed a turnaround. But, while new jobs are being created, the unemployment rate, at 9.2 percent in February, is only one-tenth of a percentage point below its year-ago rate.

In 1984 and the first half of 1985, economic activity was supported by rising exports. The net stimulus from foreign demand contributed about one percentage point to the 1985 increase in real GDP. However, domestic demand has been fueling the expansion since mid-1985. In particular, investment in machinery and equipment has enjoyed substantial increases. Consumer sentiment has also improved thanks to higher employment, lower inflation, reductions in the public sector deficit and lower interest rates.

German real GNP during 1986 is anticipated to post a year-over-year gain in the 3.5 percent to four percent range. The increase in economic activity will improve the

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employment picture. The combination of lower oil prices and an appreciating currency will contribute to significantly lower inflation in 1986. On a year-over-year basis, the rise in consumer prices is expected to be below one percent, the lowest rate of inflation since 1954.

France

Lower oil prices have also brightened France's economic prospects, bringing this country's performance more in line with the European average. Estimates of the impact of lower oil prices on the French economy show that this development alone could raise GNP growth by 1.4 percent of the 1985 level. The outcome of the recent French elections, which signaled a shift in economic policy away from state control of the economy toward a strengthening of the free market, greatly improves the economic climate and prospects for future growth.

Industrial production growth, which performed erratically during 1985, showing the weakest recovery performance among the industrial nations, rose by 3.1 percent in January compared to its year-earlier level. Industrial production is expected to strengthen in 1986, rising by 2.5 percent. Although real fixed investment fell by 0.5 percent in 1985, an improvement is expected for 1986. Personal consumption is forecast to rise by 2.5 percent in 1986 thanks in part to tax cuts. As a result, forecasts for real GNP growth this year range from 2.3 percent to three percent, compared to last year's increase of only 1.3 percent. Consumer price increases are anticipated to range between two percent and three percent during 1986 compared to a 5.8 percent increase in 1985.

Italy

Steady economic growth is set to continue in Italy, with the real economy expected to grow by 2.5 percent to three percent, compared to official estimates of a 2.2 percent rate of growth in 1985. In contrast to the other European countries, domestic demand provided the major contribution to 1985 growth. Despite concerns over the country's large budget deficit and the public sector's borrowing requirement, business confidence is improving. Nonresidential investment is the strongest component of total investment while public investment is depressed by budget stringency, and new construction remains weak as a consequence. Personal consumption is anticipated to grow modestly in 1986. Lower oil prices are expected to have a massive impact on the 1986 trade balance. Provisional estimates suggest that a comfortable balance on current account can be anticipated for this year, following a deficit in 1985.

As elsewhere, the decline in oil prices has greatly enhanced prospects for lower inflation in Italy. Although February consumer prices were 7.6 percent above their year earlier level, it is expected that the government's target inflation rate of six percent will be achieved in 1986. As is the case with the other European nations, the expansion, so far, has not resulted in lower rates of unemployment. In fact, the unemployment rate continues to rise, reaching 13.7 percent of the labor force in January compared to 13.1 percent a year earlier. However, major reforms to the *scala mobile*, the Italian wage indexation system, were finalized in December.

Great Britain

The United Kingdom was the only industrial nation enjoying faster economic growth in 1985 than in 1984. Real GDP rose at a relatively strong 3.3 percent rate due, in part, to the end of the miners' strike in March 1985. Although concerns about the impact of lower oil prices on Britain's revenues persist, the recently announced budget has increased optimism about this country's growth prospects. The new budget includes a cut in basic tax rates, and other tax reductions, including the abolition of the gifts tax and tax relief for corporate gifts to charity. Moreover, buoyant nonoil revenues are partially compensating for lower oil revenues, resulting in a reduction in official estimates of the public sector's borrowing requirement for FY 1985/86.

Consumer demand is at a record level in the United Kingdom, rising 3.3 percent during the fourth quarter of last year. As a result of the announced tax cuts, personal consumption is expected to grow faster this year than in 1985. Business confidence remains stable as gross trading profits of industrial and commercial companies rose by almost twenty percent during the first nine months of last year. Government estimates place the increase in investment during 1986 at five percent, a significant improvement over 1985. Housing construction is also showing signs of improvement.

British inflation is expected to decelerate this year. Current estimates anticipate that inflation will increase by four percent in 1986 compared to 6.1 percent in 1985. As elsewhere in Europe, however, the unemployment rate, at 13.3 percent of the labor force, remains high.

Japan

Industrial output in Japan is sagging. Fourth quarter output was down 0.7 percent from the previous quarter, but up 1.2 percent compared to the fourth quarter of 1984. Survey evidence indicates a slowdown in capital investment growth, which some observers estimate will decelerate from a 7.8 percent growth rate in 1985/86 to only 3.8 percent in 1986/87. Investment in the manufacturing sector, which was stagnant last year, is anticipated to decline in 1986. Poor export prospects, owing to the appreciation of the yen, are blamed for this expected outcome. Export growth fell from 18.1 percent in 1984 to 7.8 percent in 1985. Despite the overall slowdown, however, personal consumption is expected to expand moderately, rising by 2.8 percent in 1986.

The depressing effect of the strong yen on exports has increased pressures for more expansive fiscal and monetary policies to boost domestic demand. In response, the Japanese government is expected to review the tax incentives which keep savings high. The broad measure of the money supply has been posting steady increases (up 8.8 percent in January over its year earlier level). The discount rate, which was cut from five percent to 4.5 percent at the end of January, and to four percent in early March, is expected to be cut again in order to further stimulate domestic demand.

As a result, official government estimates place real GNP growth in 1986 at a relatively strong four percent while private forecasters expect an increase of about 3.5 percent. The appreciation of the yen and lower oil prices have significantly reduced inflation prospects, with some analysts expecting zero inflation in 1986 following a 2.1 percent rise in 1985. Unemployment continues to fluctuate under three percent of the labor force.

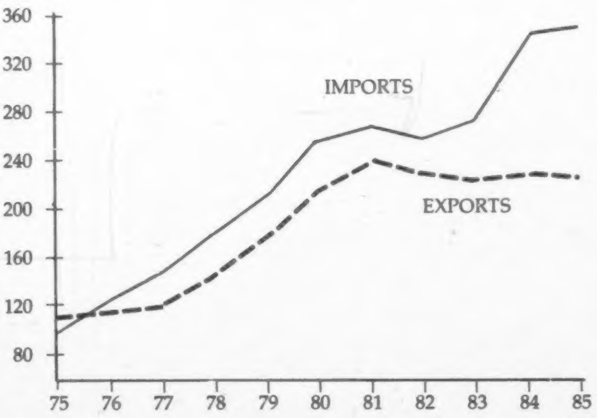
Other Factors Affecting U.S. Trade

While we have seen the performance of U.S. exports improve markedly during the past three months, factors other than improved growth in the industrial nations will affect our trade balance. This section summarizes these other factors affecting U.S. trade.

Despite the first quarter improvement in real net exports, the trade deficit remains high. Conventional wisdom lays a large part of the blame for our current trade problems on a *flood* of imports which had a significant negative impact on measured GNP last year. However, as Chart 1 shows, merchandise imports have been on a rising trend since 1975 and recent performance does not suggest a significant deviation from that trend. What is striking about the graphed data is the performance of merchandise exports, which peaked in 1981 and have yet to recover.

CHART 1

U.S. MERCHANDISE TRADE
($ billions)
1975 to 1985



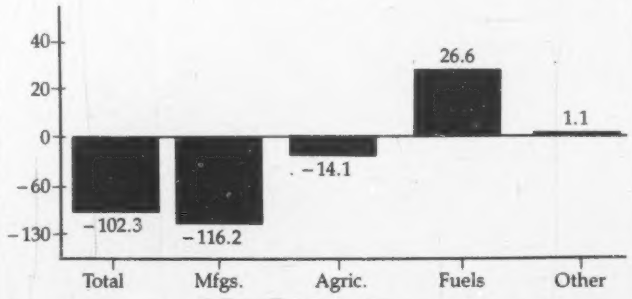
Merchandise trade is primarily composed of trade in manufactures, fuels and agricultural products. Although lower oil prices imply a net savings of $16.5 billion on the oil bill of the United States, this only represents 0.4 percent of GNP. Thus, the decline in oil prices, while important, will not be a major contributor to the narrowing of the trade gap. Trade in agricultural products accounts for 17 percent of merchandise exports and eight percent of imports. But despite the slide in the dollar, prospects for this sector are not all that bright.

The international economy is in the midst of structural changes which have shifted comparative advantages among nations and products. In the case of agriculture, these advantages have shifted away from the United States. The $24.7 billion surplus in agricultural goods trade that the U.S. enjoyed in 1981, fell to $8.4 billion (at an annual rate) during the first half of 1985. It is unlikely that the surplus in agricultural trade will return to previous levels, particularly when global food supplies are growing faster than demand. This increase in food supplies stems from factors such as improved technology and infrastructure abroad and increased reliance on market price incentives (particularly in the developing and socialist nations), which are unlikely to be turned around.

Trade in manufactures, which comprises 70 percent of merchandise exports and a similar proportion of merchandise imports, is the key to understanding the U.S. trade gap. Moreover, not only is trade in manufactures the largest component of merchandise trade, it is also responsible for the bulk of the 1980-1985 deterioration in the trade balance (see Chart 2). Thus, a massive swing in manufactures trade is needed to significantly narrow the U.S. trade and current account deficits.

CHART 2

CHANGES IN U.S. MERCHANDISE TRADE
($ billions)
1980 to 1985



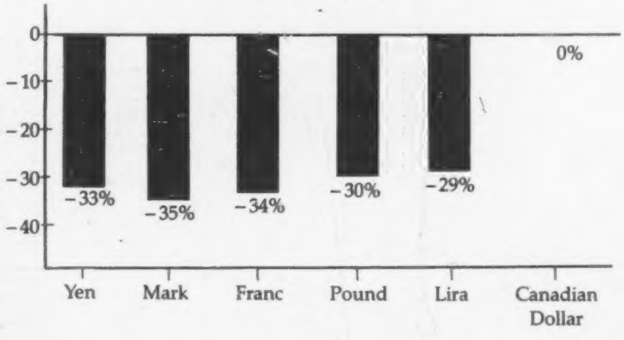
Separating manufacturing trade by key trading partners we find that the debt servicing problems of some developing nations had a significant impact on U.S. trade. Although the developing nations (LDCs) account for only about 30 percent of U.S. manufactures trade, they were responsible for over 40 percent of the deterioration in the balance on manufactures which occurred between 1980 and 1984. Moreover, between 1981 (when the U.S. manufactures trade surplus with the LDCs peaked at $24.9 billion) and 1984 (when that surplus had become a $28.8 billion deficit), the Latin American LDCs accounted for 35 percent of the $53.7 billion deterioration in manufacturing trade with the LDCs. For reasons mentioned in last month's OUTLOOK, while the fall in oil prices has worsened the ability of the indebted oil exporting LDCs to service their debt, it has significantly improved the outlook for the majority of the indebted nations which are net importers of oil. Increased world trade will enhance growth in the LDCs as well as in the industrial West. Although a surge in LDC imports is not expected, indeed it would not be desirable, it is expected that improved economic activity in these nations will, in the least, stem the deterioration of our trade balance with this group of countries.

But while trade with the LDCs should not be overlooked, our most important trading partners are the industrialized nations of Western Europe and the Pacific Basin. The bulk of the $104.5 billion 1985 deficit in U.S. manufactures trade is accounted for by trade with Japan, the newly industrializing countries (NICs) of East Asia, the European Community and Canada. In 1984, almost 55 percent of U.S. manufactures exports were destined for Canada, Japan and the EEC, while 64.9 percent of our manufactures imports came from those areas.

The depreciation of the dollar plays a major role in the trade adjustments now underway. As Chart 3 shows, the dollar's slide from its peak in February of last year, *vis-à-vis* the currencies of the major industrial countries has been substantial. This adjustment in our currency with respect to that of our major trading partners will continue to improve the U.S. trade balance. Nevertheless, there are certain factors which, for the moment, mitigate the impact of the dollar's decline on exports and imports. The dollar's decline (24 percent on a real effective basis), although substantial, was from a historically high peak and it has yet to reach the levels which prevailed in 1980 when the trade deficit was of a more modest size (see Chart 4). More importantly, however, the value of the U.S. currency has not yet deteriorated with respect to the currencies of the Latin American nations, the Asian NICs and Canada, which together account for 43.3 percent of U.S. imports of manufactures.

CHART 3

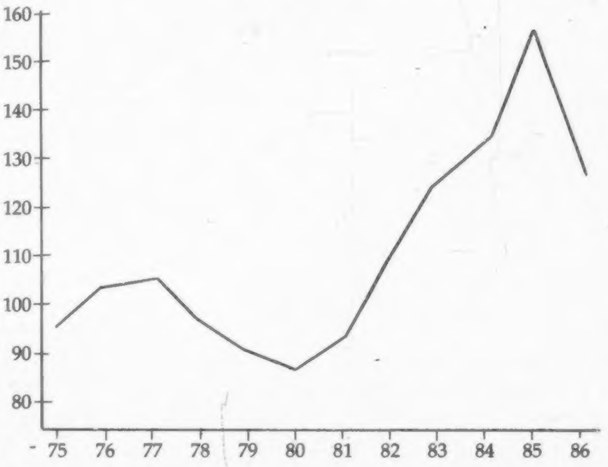
PERCENT CHANGE IN DOLLAR EXCHANGE RATES
from February 1985



Source: See Table 1.

CHART 4

EXCHANGE VALUE OF THE DOLLAR
(trade weighted index)



As Chart 3 shows, the U.S. dollar has not declined at all against the currency of our most important trading partner: Canada. Our northern neighbor was the destination for 25.6 percent of U.S. exports of manufactured products, and the source of 20.2 percent of U.S. manufactures imports in 1984. Moreover, the U.S. dollar has continued to appreciate in relation to the currencies of many developing countries. For instance, between September 1985 and March 1986, the dollar appreciated by 48 percent against the Brazilian cruzeiro; and it has not changed against the Korean won, which is pegged to the dollar. In fact, most LDCs and NICs peg their currencies either to the dollar or to a basket of currencies in which the dollar has the largest weight. As a result, there has been no significant dollar depreciation against these countries' currencies. This implies that while our trade deficit with Japan and Europe will indeed decline, the impact on our trade balance may be less than expected as imports of, for example, Japanese goods are substituted by imports of, say, Korean goods.

Other factors, independent of oil prices or the decline in the dollar's value, also affect the American balance of trade. Foreign exporters have used the past five years of

TABLE I
UNITED STATES ECONOMIC OUTLOOK 1986-1987
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates.)

	QUARTERS										YEARS		
	Actual			Forecast							Actual	Forecast	
	85:3	85:4	86:1	86:2	86:3	86:4	87:1	87:2	87:3	87:4	1985	1986	1987
GROSS NATIONAL PRODUCT													
Real GNP	3.0	0.7	3.2	4.9	5.0	7.1	6.1	4.1	4.0	3.8	2.2	3.5	5.3
Consumption	4.6	0.1	4.3	4.5	4.4	4.7	3.8	2.4	2.5	2.3	3.3	3.5	3.6
Residential Investment	8.5	5.7	9.7	11.5	0.1	2.3	2.2	-2.0	-3.9	-3.9	1.7	7.2	0.5
Nonresidential Investment	2.4	11.3	-13.6	8.4	8.0	14.5	11.1	7.9	9.5	7.8	9.7	2.8	10.1
Equipment	3.0	13.5	-17.8	10.9	9.8	17.0	11.7	7.4	9.7	7.4	8.8	3.0	11.0
Structures	1.2	7.2	-5.1	4.0	4.9	10.0	9.9	8.9	9.1	8.5	11.4	2.4	8.6
Exports	-5.1	6.6	11.9	13.0	16.1	21.5	14.8	12.8	11.6	10.8	-3.0	8.4	15.0
Real Net Exports	-119.8	-140.8	-126.0	-114.4	-100.0	-83.7	-74.4	-64.4	-54.1	-43.4	-108.4	-106.0	-59.1
Imports	12.8	24.5	-3.6	-0.1	0.1	2.8	4.3	2.5	1.6	1.0	2.7	6.0	2.3
Government Purchases	37.3	23.4	-32.2	-6.3	-2.3	0.0	0.3	0.0	-0.2	-0.2	10.3	-3.3	-0.7
Final Sales	5.0	1.3	-0.4	5.3	5.3	7.0	5.2	3.7	3.8	3.5	3.9	2.9	5.0
Change in Business Inventories (82$B)	-1.8	-6.3	26.0	22.8	20.7	22.0	30.5	35.1	37.2	40.1	5.7	22.9	35.7
Industrial Production	3.1	2.0	2.5	8.3	8.3	13.0	10.6	6.6	6.7	6.4	2.6	4.9	9.1
Total New Car Sales (mill.)	12.4	10.3	11.0	11.3	11.5	11.7	12.1	12.0	11.7	11.7	11.2	11.4	11.9
Domestic Car Sales (mill.)	9.4	7.0	7.9	8.3	8.6	8.9	9.1	8.8	8.7	8.6	8.3	8.4	8.8
New Housing Starts (mill.)	1.69	1.77	1.99	1.95	1.96	2.00	1.99	1.93	1.92	1.89	1.74	1.98	1.93
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	7.2	7.0	7.1	7.0	6.8	6.4	6.1	5.9	5.8	5.6	7.2	6.8	5.9
Compensation	3.0	3.2	5.9	2.7	2.8	2.8	3.9	3.4	3.7	3.8	3.7	3.7	3.3
Productivity	0.4	-3.4	1.7	2.8	2.4	3.7	2.4	1.3	1.5	1.4	-0.1	0.9	2.3
Unit Labor Costs	2.6	6.9	4.1	-0.1	0.3	-0.9	1.4	2.0	2.1	2.4	3.8	2.8	1.0
Consumer Price Index	2.4	4.4	1.5	-1.3	1.8	1.8	2.3	2.6	2.9	3.0	3.5	2.0	2.1
Implicit GNP Deflator	2.9	3.3	2.5	1.9	2.4	2.1	2.4	2.9	3.0	3.1	3.3	2.6	2.5
Prime Interest Rate (%)	9.5	9.5	9.4	8.5	7.9	7.6	7.4	7.4	7.6	7.6	9.9	8.4	7.5
3-mos. Treasury Bill Rate (%)	7.1	7.2	7.0	5.5	5.0	4.8	5.1	5.2	5.5	5.5	7.5	5.6	5.3
Corporate Bond Rate (%)	11.0	10.6	9.6	8.5	8.3	8.1	8.1	8.3	8.4	8.4	11.4	8.6	8.3
Real Personal Disposable Income	-4.6	2.4	5.7	2.9	2.2	3.2	3.8	1.6	1.6	1.0	1.4	3.5	2.0
Profits from Current Production ($B)[1]	221.7	218.8	230.9	234.9	246.8	266.6	275.3	286.3	296.9	306.4	211.2	244.9	291.2
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts											736	793	862
Unified Outlays											937	990	1015
Unified Deficit											-201	-197	-153

[1] After-tax corporate profits with inventory valuation and capital consumption adjustments.

[2] Unified budget figures on a fiscal year basis.

SOURCE: U.S. Chamber of Commerce, Forecast Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

The April/May forecast assumes that spending cuts along the lines of the Gramm-Rudman-Hollings Act's requirement are enacted in FY 1986 and FY 1987. However, the cuts fall short of the Gramm-Rudman-Hollings deficit reduction goals. Tax increases or reform are not anticipated. The nation's money supply (M1) is assumed to grow by 8.3 percent in 1986 and 7.2 percent during 1987. The trade weighted exchange value of the dollar falls by 14 percent during 1986 and 4.5 percent in 1987. The price of imported oil averages $18.75 per barrel in 1986 and $14.00 in 1987. The federal minimum wage is not expected to increase.

dollar appreciation to increase their penetration of U.S. markets, an endeavor which required substantial investments. It is unlikely that they will easily give up these market shares, particularly if sales in the U.S. remain profitable. Moreover, many U.S. firms, importers as well as multinationals, have entered into long-term contracts with foreign suppliers that will not be quickly revised. And finally, some U.S. firms may actually mitigate the competitive advantage that the dollar depreciation affords them by raising their own prices in an attempt to increase profit margins. This ill-advised strategy runs against known economic relationships. In the least, it prevents them from reaping the full benefit of the currency realignments now underway and may even prevent some firms from increasing their domestic market shares.

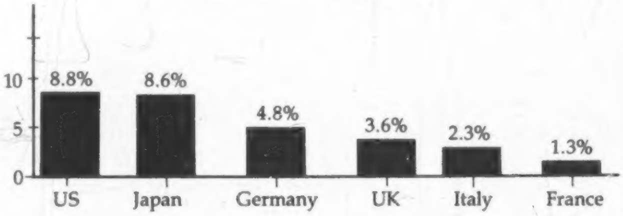
Conclusion

What policy actions are necessary to correct the imbalance in world trade and reduce the U.S. trade deficit? The Morgan Guaranty study mentioned above shows that a significant reduction in the U.S. current account deficit can best be achieved through industrial country cooperation. The scenario that the analysis envisages includes (1) an increase in annual economic growth in Japan and Western Europe which averages only 0.6 percent higher than anticipated under current fiscal and monetary policies, and (2) a further depreciation in the value of the dollar. If this were to occur, their simulation shows that the U.S. current account deficit would be halved by 1990. More importantly, this would be accomplished without increased inflation in the United States, as could occur if we were to rely only on dollar depreciation to reduce the trade deficit, or a U.S. recession which would reduce the deficit by curtailing U.S. import demand. The enactment of fiscal policies that would result in such an outcome would not only be beneficial to the United States, but to the world economy as a whole since the major industrial nations would be growing more rapidly.

More stimulative fiscal policies are clearly needed in our major industrial trading partners. A recent report from Germany's Kiel Institute notes that although lower oil prices and interest rates will contribute to higher growth this year, this expected outcome does not result from "fundamental changes in conditions [which strengthen] economic dynamics." In fact, the report notes that "fiscal policies have hardly been reformed, leaving tax ratios high."

As noted in previous issues of the OUTLOOK (see the October 1984 issue, tax rates in Europe remain significantly higher than in the United States. As a result, the recovery in industrial production has not been as rapid in these countries as in the United States. Chart 5 shows increases in industrial production in the U.S., Japan, and the major European economies since the end of the recession. The graph clearly shows that the European economies have lagged behind the United States and Japan and that there is much room for improvement. The timing could not be more propitious, since the appreciation of the European currencies and the yen with respect to the dollar, and the decline in oil prices have significantly reduced the likelihood of increased inflationary pressures even in the face of increased domestic stimulus in these countries. The outlook for such policy changes in our major trading partners is good. In fact, some of these nations have already announced their intentions to reduce taxes.

CHART 5
INCREASE IN INDUSTRIAL PRODUCTION
(percent change, 82:4 to 85:2)



Source: Federal Reserve Bank of St. Louis.

This month's outlook assumes that proposals to increase domestic stimulus in our major trading partners are enacted. The value of the dollar is assumed to continue to decline during the next two years, but at a more moderate pace than during the past 14 months. Although it is now very difficult to predict the path of oil prices, for purposes of the forecast we have assumed that they average $18.75 per barrel in 1986 and stabilize at $14 per barrel in 1987. As a result, real net exports are expected to improve markedly. The deficit on real net exports declines from $108 billion in 1985 to $59 billion in 1987.

PROTECTIONIST PRESSURES CONTINUE TO RISE

by
Rajni Bonnie Ohri

As the previous article demonstrates, the decline in the dollar's value has begun to improve the international price competitiveness of U.S. exports, thereby reversing the trend toward ever larger trade deficits. Nevertheless, pressures for the enactment of restrictive trade measures have recently intensified. Calls for increased government intervention in international trade are now common, ranging from pleas for isolated policies to cope with the problems of specific groups, to proposals for comprehensive programs to manage trade. Formulating international trade policy is difficult in such an atmosphere.

Protectionist bills have been introduced in the Congress in large numbers during the past year. Among the most important factors contributing to this increase in protectionism are the large number of workers and industries affected by international trade, recent macroeconomic performance, and the belief that other countries are engaging in unfair trade practices. As this article shows, the case for protectionism is a misleading basis for policy.

Increased Dependence on Trade

The volume of world trade in goods grew nine percent in 1984, one of its fastest ever rates of growth. But this rate of growth is not expected to last. Between 1950 and 1973, each one percent rise in world income was accompanied by a 1.6 percent rise in world trade. Between 1973 and 1984, it was accompanied by only a 1.1 percent increase. In other words, the responsiveness of world trade to income has fallen by nearly a third since the 1960s. And in 1985, world trade slowed dramatically, growing by less than three percent.

One reason for the concern over the rise in protectionist sentiment is that the United States is becoming more dependent on world trade. From 1960 to 1984, the ratio of imports to GNP rose from 4.6 percent to 11.8 percent while the share of exports to GNP increased from 5.7 percent to 10.2 percent. These trends were a part of a rising global interdependence as virtually all countries are engaging more intensively in trade.

An implication of this growing international orientation is the increase in the proportion of the U.S. labor force that depends on international trade for employment and income. Specifically, the proportion of manufacturing employment facing import competition rose from 8.4 percent in 1970 to 14.7 percent in 1980, and the proportion of manufacturing employment directly related to exports rose from 8.1 percent to 14.5 percent. Other productive factors also have an increasing stake in foreign trade. During the same period, the import-related share of manufacturing value increased from 8.3 percent to 14.4 percent, and the export-related share increased from 8.5 percent to 15.1 percent. Moreover, increasing trade has had a disproportionate impact on certain sectors of the economy. The effects have been concentrated in the tradeable goods sectors—those industries that export a sizeable portion of their output, industries that compete with imports, and their suppliers. Thus, many of the recent calls for protection stem largely from long-run losses in international competitiveness due to shifts in comparative advantage. While such shifts benefit the economy by allocating resources to more productive uses, they can be difficult and costly in the short-run. Protectionist pressures arise to forestall these costs.

Industries that have lost their comparative advantage have suffered from increasing trade. Growing disadvantages have occurred in footwear, apparel and textiles, basic iron and steel, and motor vehicles. The growing trade deficits in these sectors largely reflect shifts in comparative advantage to other countries. Production techniques in these industries have become fairly standardized, with the result that these goods can be produced by relatively unskilled workers. Over time, the higher productivity of U.S. workers producing these goods has disappeared, and high domestic wages have made U.S. costs uncompetitive. For example, operating under the price umbrella of quotas, the steel industry pays wages 31 percent higher than the U.S. average and 23 percent higher than the average manufacturing wage. Capital, therefore, has moved to countries with relatively lower wages.

As a result, in 1984, imports claimed a significant portion of the U.S. market for the following products: nonrubber footwear (49.8 percent), apparel (20.2 percent), steel (16.7 percent). Although most major categories of American industry face import penetration ratios of 20 percent or less, a majority of them have experienced an increase in the proportion of domestic demand satisfied by foreign producers. Moreover, in important categories within the broad industry classifications, imports account for a major share of the domestic market. For instance, the ratio of imports in the machine tools industry is 31 percent, even though for the nonelectrical machinery industry as a whole, it only reaches 14 percent. At the same time, however, two industries in which foreign producers have made significant inroads into domestic markets—basic chemicals and television and radio sets—have not experienced further increases in the import penetration ratio since 1981.

Indeed, competitive pressures have forced U.S. industries to lower production costs and increase productivity and innovation, thus becoming more efficient. This would not have occurred behind protective barriers. And, closing our markets to foreign goods would boomerang against us even under the unlikely event that foreigners do not retaliate. As U.S. demand for imports declines, so would U.S. exports, since foreign countries, faced with a shrinking export market, would experience declines in economic activity and concomitant reductions in their demand for imports, including U.S. products.

Some industrial sectors have benefited substantially from increased international trade. Interestingly, the industries within manufacturing that have had the highest growth rate of employment since 1980 have several factors in common: an increased worldwide demand for their products, little if any protection, lower than average manufacturing wages, and typically increased import penetration into their markets. Electronics and computers are two examples.

Macroeconomic Factors

Another reason for resurgent protectionism is the effect that economic conditions have on employment. Many argue that in order to "save American jobs" imports must be restricted. The belief is that higher trade barriers will promote domestic employment by substituting domestic production for imports without restricting export-related employment through foreign retaliation. Indeed, protection may save jobs in import-competing industries, but this is likely to be matched by the less visible loss of jobs elsewhere in the economy.

While some observers claim that each additional billion dollars worth of imports costs 25,000 to 30,000 jobs, the U.S. has nonetheless created over 9 million new jobs over the past three years, a period during which the trade deficit exploded to record levels. Thus, the expansion of imports has not come at the expense of aggregate employment in the United States. Such a record stands in contrast to those of the other developed countries, many of which are running trade surpluses but have continued to experience job losses.

Much of the recent protectionist pressure is undoubtedly related to high unemployment in 1981 and 1982 and to subsequent macroeconomic events. Widespread unemployment increased protectionist sentiment across an array of industries and intensified pressures for import relief in the steel, textile and automobile industries. Moreover, the recession was accompanied by a rapid appreciation of the dollar, which induced more stagnation in the tradeable goods sectors than in the general economy.

The ensuing recovery has not moderated protectionist pressures because the dollar continued to appreciate until last year and, by many standards, it is still considered too high. While the full impact of the dollar decline is not expected to be felt for some time, several industry groups and individual companies claim that they have experienced increases in foreign orders, as American goods and services become less expensive abroad. Indeed, according to the American Paper Institute, exports of wood pulp to Western Europe and Japan were up 49 percent in January and February of this year from the same period in 1985. They attributed this improvement to the dollar's slide. The David R. Webb Company of Indiana claims that their export orders for lumber were up 80 percent this year due to the lower value of the dollar. Some companies with overseas subsidiaries such as Deere & Company, are already benefiting as their profits from foreign units are worth more when translated into dollars, adding to their overall profitability at home.

American consumers, who for several years have enjoyed inexpensive imports, will soon see an increase in the dollar value of imported goods. Japanese products, in particular, are bearing higher prices because of the yen's surge against the dollar. With foreign currencies rising, all types of imports, including televisions, motorcycles, beer and personal computers, are likely to become more expensive. In April, Nissan raised its prices on new cars and trucks by an average of 3 percent; this followed a 4 percent increase as recently as December. Volkswagen, Volvo, Toyota and Honda have also raised prices on new cars and further increases are expected. Matsushita Electric Corportion of America is already planning a new round of price increases after one round took effect in January. And Sony and Sanyo are also planning further price hikes that will range up to 15 percent on selected items. But most of the price increases have yet to come, partly because suppliers are tied into contracts that bear fixed prices and because of the lag in putting price increases into effect.

Unfair Trade Practices

Still another reason for rising protectionist sentiment is the view that other countries are not fair in promoting their exports and restricting their imports. Those holding this view advocate specific protectionist threats to force other countries to remove or forestall their trade restrictions. For many, the idea of free trade has been replaced by the idea of "fair trade" which would make the government responsible for forcing other countries to provide a level playing field.

Much of the impetus for protectionist actions stems from frustration over the U.S. trade deficit with Japan. Some observers accept this deficit of nearly $50 billion in 1985 as evidence that the Japanese market is closed to U.S. products such as telecommunications equipment and other high-tech goods. Elsewhere, the United States is currently involved in a spate of trade disputes with Canada, including flaps over alleged provincial subsidies to Canadian lumber producers and restrictions on cattle and hog imports. In addition, the Administration is threatening to place quotas on imports from the EEC in retaliation for actions that could jeopardize $1 billion in U.S. farm sales to Spain and Portugal. Trade frictions have intensified between the U.S. and Western Europe over a variety of products that include agriculture, steel, telecommunications and passenger airplanes.

As a result, the U.S. is now taking a harder line on trade policies in other ways as well. For example, the U.S. is revising its policy of Generalized System of Preferences toward the richer less developed countries. One possible revision would require these foreign governments to make concessions in order to retain their duty free access to U.S. markets. Legislation is also pending to provide for the automatic erection of trade barriers when imports reach a certain market share. A revision of the Escape Clause of the Trade Act is under consideration to provide lower interest loans to increase the ability of foreigners to buy U.S. products.

Congress also insists on domestic content restrictions and "buy American" provisions in public and private contracts. The 1982 gas tax act specified that, in federally funded construction projects, cement must be 100 percent American-made unless that raises the cost by more than 25 percent. In addition, the United States is involved in promoting agricultural exports through programs of blended credits designed to offset similar subsidies by the EEC.

Professor Gary Haufbauer estimates that the percentage of U.S. imports covered by protection has risen to 21 percent in 1985 from eight percent in 1975. The trend toward protectionism has accelerated in the last five years, largely due to the dollar's steep rise in value. The strong dollar, combined with the powerful economic recovery, encouraged a flood of imports and increased domestic industries' demand for protection. Although the Reagan Administration claims to be vigorously opposed to trade barriers, it has found it politically impossible to fully resist these pressures.

Costs of Protectionism

The costs to society of erecting trade barriers outweigh the benefits to individual groups because restricting trade causes substantial economic inefficiency. The costs are the higher prices domestic consumers must pay for goods shielded from foreign competition. These higher prices are, in effect, hidden taxes. Part of the hidden tax is distributed to domestic workers and firms that produce the protected goods in the form of higher profits, wages and employment. Some of the tax, however, is dissipated in lower economic efficiency, which benefits no one. It is a particularly regressive tax, because the increased prices, particularly for consumer goods, fall most heavily on lower income Americans who spend a greater percentage of their income on these products. Empirical estimates show that recent U.S. trade barriers have indeed been an inefficient means of increasing the incomes of workers in the tradeable goods sectors. These estimates reveal that eliminating the trade barriers and directly compensating workers in the affected industries for their lost income would be much less expensive than limiting imports.

Clothing tariffs and quotas provide a dramatic example of the high costs of U.S. protectionism. The United States has a tariff averaging 26 percent of the value of all clothing imports. According to a study by the Federal Reserve Bank of New York, which conservatively assumes that trade barriers do not raise the price of domestically manufactured clothes, consumers pay a tax as high as $12 billion a year to protect the U.S. textile industry. A more comprehensive measurement, according to Professor Haufbauer, puts the figure at $27 billion, or $42,000 for every job saved.

Other imported products that are protected by U.S. trade barriers are:

Steel: The U.S. signed a quota agreement with the EEC in October 1982 limiting steel imports. At the same time, Japan initiated a system of "voluntary" steel export restraint to avoid more direct U.S. trade action. These measures substantially reduced European and Japanese steel shipments to the United States but shipments from developing countries soared in their place. In September 1984, the United States began negotiating more "voluntary" export restraints with other steel suppliers designed to limit total steel imports. The Federal Reserve Bank of New York conservatively estimates that these restraints cost consumers about $2 billion a year.

Book Manufacturing: The U.S. book printing industry is largely shielded from foreign competition. To be eligible for U.S. copyright protection, virtually all books and periodicals sold in this country must also be printed and bound here. That restriction costs consumers an estimated $500 million each year.

Ceramic tiles: Makers of ceramic floor and wall tiles are protected by tariffs that average 25 percent of the import value. The cost to consumers is about $116 million a year.

Peanuts: To prevent imports from undermining its peanut price support program, the government has kept a strict quota on imported peanuts since 1953. The approximate annual cost to the consumer is $170 million.

Rubber Shoes: The U.S. rubber footwear industry is shielded by high tariffs that in some cases have changed little since the 1930s. The cost to consumers is over $230 million a year.

Autos: Under a "voluntary" agreement, Japan began restricting auto exports to the United States in April 1981. As a result, according to the New York Fed, Japanese car prices rose over $2,000 and cost consumers an estimated $4.5 billion in 1984. Quotas on automobiles alone have increased the cost of imported cars by $1,400, and the price of domestic cars by over $600. Brookings Institution economist Robert Crandall estimates that with 1984 sales of nearly eight million U.S. cars, the quotas took $3.2 billion out of the pockets of consumers.

Conclusion

The primary objective of trade policy should be to keep world markets open to international specialization and exchange. The benefits of free trade far outweigh the advantages that narrow sectors gain through protectionism. Government management of trade through protectionism will not solve problems that result from international macroeconomic imbalances.

Undoubtedly, there are some very real problems. Some industries are losing their ability to compete in the world market, causing great hardship to many workers. Some exporters are facing insurmountable barriers to the export of their goods and services. But protectionism is not the answer. Indeed, it would worsen the very problems it promises to fix. Its costs in higher prices, reduced trade opportunities, the stifling of innovation, and the threatened when an alternative set of policies is put into effect: policies that will create new jobs, increase our com- ed when an alternative set of policies are put into effect: policies that will create new jobs, increase our competitiveness here and abroad, and raise the general standard of living.

TANKS OR TOASTERS

by
Richard W. Rahn

Whether you capitalists like it or not, history is on our side, we will bury you.
Nikita Khrushchev—1957

Far from burying the United States and other capitalist economies, it has become increasingly clearer that the forces of history are running against the Soviets rather than with them. Soviet economic growth is now down to a crawl.

During the first fifteen years following Khrushchev's prediction, it was indeed true that Soviet economic growth was relatively faster than ours, albeit from a lower base. In 1960, Soviet GNP (Gross National Product) was approximately 49 percent of U.S. GNP. By 1975, it had reached a high water mark of 58 percent of U.S. output. Since then, however, Soviet economic growth has slowed down relative to U.S. growth, and by 1985, it had fallen to approximately 53 percent of the U.S. level. Moreover, in per capita terms, Soviet GNP growth has been even weaker than ours. Both the United States and the Soviet Union experienced a slowdown in GNP growth during the 1970s and early 1980s. But, the slowdown in U.S.S.R. economic activity was more severe than ours, and while U.S. growth has bounced back sharply since 1983, Soviet per capita GNP growth continues on a downward path. Now if present trends continue, and there is every reason to believe that they will, by the end of this century, or a mere fifteen years from now, the Soviet economy will be smaller in relation to the U.S. economy than it was at the time of Khrushchev's famous boast.

Growth prospects in the United States, Southeast Asia and most of Western Europe are projected to improve significantly over the next two years, in large part due to falling oil prices. As was discussed in last month's ECONOMIC OUTLOOK, every $10 per barrel drop in the price of oil is expected to increase U.S. real GNP by 0.8 percent during the first year and 1.6 percent during the second year over the baseline projection. For the Soviets, however, the effect of lower oil prices is just the opposite. Until recently, approximately 70 percent of the U.S.S.R.'s hard currency earnings came from trade in petroleum, petroleum products, and natural gas. As a result, the Soviets can expect to lose 20 percent to 40 percent of their hard currency earnings this year due to the drop in the price of oil that has already occurred.

Many analysts believe that the Soviets would not have achieved even the meager growth rates of recent years without the importation of substantial amounts of Western machinery and technology. Thus, a fall in hard currency reserves not offset by additional international borrowing will force them to cut back on both the legal and illegal acquisition of Western machinery and technology. In addition, it will become increasingly more difficult for the U.S.S.R. to provide economic and military aid to their client states.

Despite the obvious immorality of the position, the communists have historically justified the oppression of the citizenry and denial of basic human rights as necessary to improve the overall standard of living. Recent Soviet economic performance demonstrates the hollowness of such justification. Perhaps the most telling indictment of the Soviet system is the fact that, among the industrialized nations, only in the U.S.S.R. is life expectancy falling and infant mortality increasing. It is now estimated that the average Soviet man can expect to live to about sixty years of age, compared to his American counterpart who will live, on average, to be seventy-two years old.

The actual hardship faced by the typical Soviet citizen is far more severe than the gross economic statistics indicate. For instance, military spending and gross investment as a proportion of Soviet GNP are three times as much as in the United States. Hence, personal consumption is far lower. In fact, a number of our most able analysts of the Soviet economic system believe that as much as 40 percent of Soviet GNP is spent for military purposes either directly or indirectly. At first glance, such an assertion might seem to be a gross exaggeration. However, even a cursory examination of Soviet production statistics makes it look plausible. For example, the Soviet Union consumes approximately 50 percent more steel per year than the United States, but relatively little goes into the production of automobiles, trucks, consumer appliances, or road, bridge, housing, and commercial construction. Where, then, does it go if not for military production? In 1985, the Soviet Union produced 45 percent more tanks and armored fighting vehicles than all of the NATO countries combined. But surprisingly, there were only 10,000 toasters manufactured for a population of 278 million.

Clearly, it is very difficult to compare Soviet economic statistics with ours, particularly since the Soviet pricing system is not based on supply and demand. By necessity, the U.S.S.R. uses prices prevailing in the West as reference points. In fact, the Soviet system could not function without these market price reference points since they would have no idea of the relative value of things, and without knowing relative values, it is impossible to make rational resource allocation or pricing decisions. As it is, many Soviet prices and labor rates are largely meaningless. What after all, is the real opportunity cost of Gulag labor? To compare relative standards of living, economists use such measures as the number of hours the typical person must work to buy a pair of shoes or an automobile. But if for most people, the product is not available or if when available is of such poor quality that it does not work properly, how meaningful is a relatively low price? Despite such measurement problems, it is clear from real output and consumption data, that the Soviet economy is seriously faltering relative to the capitalist nations.

If the Soviet leadership cared to improve the standard of living for the average citizen, they would have to either cut back on the portion of GNP which goes into military expenditures or reorganize economic policies to achieve better resource allocation and provide incentives for productive activities. This can only be achieved by decentralizing the decision-making process and hastening the privatization of major sectors of the Soviet economy. These alternatives, by necessity, would reduce the power of the central authorities. Yet given their past behavior it is unlikely they would consent to such a change. Thus, the average Soviet citizen can only look forward to either a stagnant or falling standard of living.

TABLE 1

COMPARATIVE ECONOMIC STATISTICS UNITED STATES VS. THE SOVIET UNION

	U.S.	U.S.S.R.
Per Capita GNP (1985)	$16,320	$7,442
Real per Capita GNP[a]		
1961–1975	2.3%	3.5%
1976–1982	2.1	1.7
1983–1985	3.2	1.6
Grain Production (kil/capita)[b]	1,330	620
Meat Production (kil/capita)[b]	105	61
Steel Production (million metric tons)[b]	84	154
Newsprint Production (million metric tons)[b]	5.0	1.6
Energy Consumption (bbl of oil/capita)[b]	54	33
Auto Registration (units/thousand persons)[b]	535	25
Life expectancy (men)[c]	72	60

(a) average annual growth rates.
(b) 1984 data.
(c) 1985 data in years.
Sources: U.S. Department of Commerce, C.I.A., *The Economist*.

DOES THE VALUE-ADDED TAX CONTRIBUTE TO INCREASED GOVERNMENT SPENDING AND TAXATION?

by
*Terree Alverson**

Proposals for tax increases have, once again, surfaced in Congress. This time they are being offered as a solution to the federal budget deficit problem, as a way to achieve revenue-neutrality in the tax reform process, and as a way to achieve the Gramm-Rudman deficit targets. One of the proposals under consideration is a form of the value-added tax (VAT), a method of raising revenues currently used in most European countries. This year, a value-added tax was included in the Superfund reauthorization program which has not yet passed the Congress, and a VAT-type tax, called the Business Transfer Tax (Senator Roth, Republican–Delaware), was introduced in the Senate as part of an overall tax reform program.

No other recent tax increase proposal elicits such vehement opposition (or support) as the value-added tax. Opponents argue that the addition of a VAT to our revenue system will increase the overall level of taxation and will stimulate greater federal government spending. They contend that because the VAT is basically a hidden tax, the rate is easier to raise, making it possible to increase government spending without the public's knowledge or permission. Even if the VAT is introduced as a replacement for other taxes, opponents suggest that increases in the rate will soon result in an increase in overall taxation. They point to the European experience and assert that VAT rates have risen steadily since their inception, as has federal government spending, which in Europe, has consistently been a larger percentage of output than in the United States.

Supporters of the VAT contend that it is not significantly different from other taxes, and deny the assertion that it has contributed to higher taxes or increased government spending in Europe. They claim that, because it is a broad-based consumption tax and does not bias the tax code against savings, it is more equitable than the current U.S. corporate income tax. If revenues are eventually deemed necessary to reduce chronic U.S. budget deficits, then the VAT is touted by its supporters as the best method, since it provides the least interference in the economy.

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Two recent papers, representing opposing viewpoints, have been circulated throughout the business community. The first paper, *Value-Added Taxes and the Size of Government: Some Evidence,* by J.A. Stockfisch, argues that VATs do not contribute significantly to increased government spending. The opposing viewpoint is detailed in *VAT and Small Business in North America,* a paper by Graham Bannock and Partners, Ltd. commissioned by the small business community. This report notes that non-VAT countries have historically enjoyed lower tax rates than VAT countries.

Both reports have methodological flaws which render their findings questionable. The Stockfisch report compares total taxes to the rate of growth in gross domestic product (GDP) in VAT and non-VAT countries and concludes that the relative size of government grew in some of the VAT *and* non-VAT countries. However, although the author excludes social security taxes, he does not separate VAT revenues from other taxes collected by the federal government. As a result, it is impossible to ascertain what proportion of total taxes are sales taxes, corporate income taxes, or VATs and how those proportions change over time. It is, therefore, difficult to conclude from this study whether or not the VAT was responsible for increased spending in those countries where spending grew. Moreover, the Stockfisch study ignores the fact that governments borrow heavily, and that they have engaged in deficit spending on an ever-increasing basis. To examine receipts alone in determining increased government spending does not take the complete picture into account.

The Bannock paper samples only one year (1983) in its comparison of low-tax non-VAT countries and high-tax VAT countries. Clearly, this is a fatal flaw. Too many macroeconomic factors, such as recession, may affect revenues over a short period of time, thus skewing the results. To get a complete picture, one must examine a longer period of time, and include both pre-VAT and post-VAT years, to track the average tax burden of each country.

Comparison of VAT and Non-VAT Countries

This article seeks to shed some new light on the issue of the value-added tax by examining the available data in greater detail and correcting some of the shortcomings of the Bannock and Stockfisch reports. Tables 1 and 2 show the rate of growth in the ratios of outlays and receipts to GDP in VAT and non-VAT countries between 1965 and 1982. The evidence shows that these two ratios grew more rapidly in VAT countries than in non-VAT countries. Outlays rose 46 percent faster in VAT countries than in non-VAT countries, while receipts rose 34 percent faster.

TABLE 1

THE GOVERNMENT SECTOR IN VAT COUNTRIES

1965–1982

	Average Annual Growth in Outlays as a % of GDP	Average Annual Growth in Receipts as a % of GDP	Average Annual Deficit as a % of GDP
Austria	.74	.49	−1.38
Belgium	1.41	.87	−4.29
Denmark	1.82	1.15	−0.62
France	.73	.51	−1.18
Germany	.75	.58	−2.27
U.K.	.66	.60	−3.50
Ireland	1.25	.69	−6.96
Italy	1.21	.69	−7.36
Netherlands	1.46	1.08	−2.60
Norway	.85	.94	+3.12
Sweden	1.79	1.14	+0.58
Group Average	1.15	.79	−2.41

Source: Tax Policy Section, U.S. Chamber of Commerce.

TABLE 2

THE GOVERNMENT SECTOR IN NON-VAT COUNTRIES

1965–1982

	Average Annual Growth in Outlays as a % of GDP	Average Annual Growth in Receipts as a % of GDP	Average Annual Deficit as a % of GDP
Australia	.64	.43	+ .24
Canada	.99	.68	−2.11
Finland	.54	.40	+1.79
Greece	1.00	.45	+1.57
Iceland	.40	.45	+ .56
Japan	1.26	.76	−3.03
Portugal	1.40	.79	−1.74
Spain[a]	1.00	.67	−1.04
Switzerland	.61	.59	+3.95
U.S.	.58	.33	−2.57
Turkey	.24	.90	+1.04
Group Average	.79	.59	−1.34

(a) Added a 12% VAT on January 1, 1986.

Source: Tax Policy Section, U.S. Chamber of Commerce.

Table 3 separates the time period into pre-VAT and post-VAT years, and shows during which period each country ran a deficit or surplus. Interestingly, the data shows that even before the introduction of the VAT, the rate of growth in outlays in the VAT countries was 38 percent higher than in the non-VAT countries. After the inception of the value-added tax, this rate rises to 1.29 percent of GDP, an increase of 18 percent over the previous period. Six out of the eleven countries studied (Austria, Belgium, France, Ireland, Italy, and the United Kingdom) had post-VAT increases in the average annual growth rate in budget outlays as a percentage of GDP. The rate of growth in revenues falls by 21 percent after the enactment of the VAT. Seven out of the eleven countries (Belgium, Denmark, Germany, Ireland, Norway, Sweden, and the Netherlands) showed a post-VAT decline in average annual growth in receipts as a percentage of GDP.

TABLE 3
THE GOVERNMENT SECTOR BEFORE AND AFTER THE IMPOSITION OF THE VAT

VAT Countries	Years	Average Annual Growth in Outlays as a % of GDP	Average Annual Growth in Receipts as a % of GDP	Average Deficit/ Surplus as a % of GDP
Austria	65–72	0.29	0.40	−0.01
	73–82	1.01	0.53	−2.50
Belgium	65–70	0.84	0.90	−3.56
	71–82	1.65	0.89	−5.63
Denmark	65–66	1.80	2.30	+1.56
	67–82	1.70	1.11	−0.81
France	65–67	0.30	−0.10	−0.30
	68–82	0.75	0.59	−1.36
Germany	65–67	1.00	0.60	−1.20
	68–82	0.74	0.54	−2.39
Ireland	65–71	1.23	1.40	−4.53
	72–81	1.76	0.62	−9.10
Italy	65–72	0.61	0.11	−4.34
	73–82	1.90	1.28	−9.78
Netherlands	65–68	1.73	1.70	−1.58
	69–82	1.48	0.96	−2.83
Norway	65–69	1.42	1.63	+3.36
	70–82	0.64	0.77	+3.03
Sweden	65–68	2.23	2.00	+2.95
	69–82	1.80	0.95	−0.10
U.K.	65–72	0.53	0.51	−1.35
	73–82	0.73	0.81	−5.22
Group Average	Pre-VAT	1.09	1.04	–
	Post-VAT	1.29	0.82	–

Source: Tax Policy Section, U.S. Chamber of Commerce.

Similarly, the VAT countries, on average, experienced larger deficits. The ratio of deficits to GDP was 2.41 percent in the VAT countries compared to 1.34 percent in the non-VAT countries. The data does not support the claim that a VAT will help reduce a country's budget deficit. Only two of the eleven VAT countries enjoyed surplus revenues as a percentage of GDP in their post-VAT period. The United Kingdom went from pre-VAT budget deficit to a post-VAT surplus, and Norway had surpluses in both periods. More importantly, however, seven out of the eleven nations studied (Belgium, Austria, Ireland, France, Germany, Italy, and the Netherlands) had pre-VAT surpluses and post-VAT deficits.

Table 4 shows that between 1965 and 1982 the ratio of total taxes to GDP rose more rapidly in the non-VAT countries. In 1965, taxes as a share of GDP in the VAT countries were 35 percent. By 1982, the ratio had risen by 11.2 percentage points to 46.2 percent. In the non-VAT countries, however, that ratio rose from 21.1 percent in 1965 to 37.1 percent in 1982, an increase of 16 percentage points. Although it is not possible to tell from the data why taxation in the VAT countries grew at a slower pace, it should be noted that the ratio of total taxation to GDP remains considerably higher in the VAT countries than in the non-VAT, even in the period prior to enactment of the VAT.

TABLE 4
TOTAL TAXES AS A SHARE OF GDP

Year	VAT Countries	Non-VAT Countries	Percentage Point Difference
1965	35.0%	21.1%	13.9
1973	36.1	28.3	7.8
1982	46.2	37.1	9.1
Increase*	11.2	16.0	–

*Percentage point difference 1965 to 1982.
Source: Tax Policy Section, U.S. Chamber of Commerce.

Tables 5 and 6 show the percentage of total taxation accounted for by the corporate income tax. Only three of the eleven VAT countries—France, Ireland, and Austria—experienced declines in the ratio of corporate taxes to total taxes between 1972 and 1982. Three other VAT countries—Italy, the Netherlands, and Norway—experienced increases in corporate taxation while VAT taxes as a share of total taxes fell.

This data, however, cannot be used as proof to the argument that the institution of VATs results in lower corporate taxation. Table 6 shows that six of the nine non-VAT countries for which there is data also enjoyed declines in the share of corporate income taxes in total taxation. Some advocates of the VAT argue that it can be used as a replacement tax which would allow the reduction of the corporate income tax, while maintaining rev-

TABLE 5

CORPORATE INCOME AND VALUE-ADDED TAX RECEIPTS AS A PERCENT OF TOTAL TAXATION

VAT Countries	Corporate Income Tax		Corporate Rate	Value Added Tax		VAT Rate
Austria	1973	3.4%	55%	1973	19.0%	20.0%
	1982	2.9		1982	20.0	
Belgium	1972	7.2	45	1972	18.7	19.0
	1982	6.1		1982	16.7	
Denmark	1972	2.2	40	1972	18.0	22.0
	1982	2.6		1982	22.0	
France	1972	5.7	50	1965	20.0	18.6
	1982	5.1		1982	20.9	
Germany	1972	4.8	36	1972	16.4	13.0
	1982	5.1		1982	16.4	
Ireland	1972	5.6	50	1972	4.6	23.0
	1982	4.7		1982	19.4	
Italy	1973	7.1	46	1972	15.0	8.0
	1982	8.0		1982	14.1	
Netherlands	1972	6.7	43	1972	15.8	19.0
	1982	6.8		1982	15.0	
Norway	1972	2.5	51	1972	22.0	20.0
	1982	16.5		1982	18.0	
Sweden	1972	4.0	32	1972	14.0	19.0
	1982	3.3		1982	13.0	
U.K.	1972	7.5	52	1973	3.8	15.0
	1982	9.6		1982	13.4	

Source: Tax Policy Section, U.S. Chamber of Commerce.

TABLE 6

CORPORATE INCOME TAX RECEIPTS AS A PERCENT OF TOTAL TAXATION (Non-VAT Countries)

Non-VAT Countries	Year	Corporate Income Tax	Corporate Rate
Australia	1972	15.2%	46%
	1982	9.9	
Canada	1972	11.1	51
	1982	8.0	
Finland	1972	4.5	43
	1982	4.5	
Greece	1972	3.9	48
	1982	4.0	
Iceland	–	N/A	N/A
	–	N/A	
Japan	1972	22.7	42
	1982	19.7	
Portugal	–	N/A	40
	–	N/A	
Spain	1972	7.7	35
	1982	4.6	
Switzerland	1972	7.8	10
	1982	6.2	
Turkey	1972	5.0	40
	1982	12.8	
U.S.	1972	11.2	46
	1982	7.0	

Source: Tax Policy Section, U.S. Chamber of Commerce.

enue neutrality. Although this report does not delve into the reasons behind the adoption of the VAT, the high rate of corporate income taxes in the VAT countries would indicate that the VAT was not adopted as a replacement tax. The average corporate income tax in the VAT countries is 45.5 percent, compared to 40.1 percent in the non-VAT countries (see Tables 5 and 6).

Conclusion

There does not appear to be a clear-cut case supporting the argument that a VAT tax will contribute to increased spending and taxation. But it does appear that many of the VAT countries have higher spending and tax levels as a percentage of GDP than the non-VAT countries. Moreover, most of the VAT countries had high tax and spending levels prior to the imposition of the VAT.

The enactment of a VAT clearly does not solve a nation's deficit problems. Eight of the eleven VAT countries ran pre-VAT deficits, and the deficit increased, as a percentage of GDP, after the enactment of the VAT. Moreover, two surplus countries (Sweden and Denmark) experienced post-VAT deficits. Only five out of eleven non-VAT countries (Canada, Japan, Portugal, Spain, and the United States) ran deficits during the period 1965-1982.

Many economists make the argument that the use of a VAT as a replacement for part or all of the corporate income tax is more efficient economically because it taxes consumption instead of savings. However, this is difficult to prove with the European VATs since they were add-on taxes. In those cases, corporate income taxes were not reduced, consequently, GDP growth did not change significantly.

Based on the data presented here, the case is inconclusive on whether to adopt a VAT. Other factors, such as administrative, compliance, and start-up costs raise the cost of implementation. Adding those costs onto the fact that VAT countries do have somewhat larger government spending and receipts than non-VAT countries, it would appear that, in most cases, the country that chooses a VAT might be getting more of a loser than a winner.

TRENDS IN COMMERCE
NOTES ON TABLE II
MAY 1986

by
*Martin Lefkowitz**

Gross National Product (GNP)—The preliminary estimate of Gross National Product—the total value of goods and services produced—shows that the inflation-adjusted growth rate for the first quarter was at an annual 3.2 percent rate, more than four times the growth rate for the fourth quarter of 1985. Consumer spending, which had dragged down the fourth quarter performance, rebounded in the first quarter to a 4.3 percent growth rate, while businesses started accumulating inventories. However, a lower rate of fixed investment was reported in the first quarter as a result of cutbacks in the energy industry. Real exports also showed a substantial increase while imports declined.

The Services Sector—Employment in service sector establishments jumped 271,000 in March and is now 2.8 million above its year-ago level. This compares with an increase of 102,000 jobs in the goods-producing sector over the last year. Over 96 percent of the job growth in the economy during the past year has been in services industries. However, the Department of Labor may be overstating the decline of jobs in the goods producing sector of the economy as more firms are contracting-out for services that were previously performed by their own workers.

Consumer purchases of services jumped 1.1 percent in February while consumers cut back on goods purchases. Major domestic airlines reported that revenue passenger miles flown, that is, the number of passengers multiplied by the miles flown by each passenger, reached 18.9 billion in February, an increase of 12.6 percent from its year-ago level. For the first two months of 1986, domestic passenger traffic on U.S. scheduled airlines was up 11.3 percent from the same period a year ago.

Money Supply—The nation's money supply—as measured by M-1, currency in circulation plus demand deposits—increased by 1.1 percent during March. Money supply growth has slowed to a 7.4 percent annual rate in the latest three-month period, but is still 11.5 percent above its year-ago level, and remains considerably above the Fed's target range of three to eight percent.

Employment—The civilian unemployment rate slipped one-tenth of a percentage point in March to 7.2 percent, compared to 7.3 percent in February. The number of non-agricultural payroll jobs—as measured by the monthly survey of business establishments—increased by 190,000 in March. Civilian employment—as measured by the monthly survey of households—was virtually unchanged in March at 108.8 million after seasonal adjustment.

Prices—The Consumer Price Index for all urban consumers (CPI-U) fell 0.4 percent in March for the second month in a row, the largest two-month drop in more than 36 years. For the first three months of the year, consumer prices fell at an annual rate of 1.9 percent, the best quarterly performance since 1954. Much of the decline was attributed to a record 12 percent fall in gasoline prices, more than double the 5.9 percent February drop. Food prices, which fell a sharp 0.6 percent in February, edged upward by 0.1 percent in March. With oil prices continuing to drop sharply, experts predict that the April index should show a similar decline at the retail level.

Wholesale prices of finished goods decreased 1.1 percent from February to March. For the first three months of this year, the index has fallen at an annual rate of 12.4 percent, the largest decline since 1947. The major contributing factor was a 21.9 percent plunge in wholesale gasoline prices. Food prices rose 0.3 percent, the first increase this year, following a 1.6 percent decline in February.

Crude goods prices fell 2.8 percent in March, following a 5.0 percent decline in February. Intermediate goods prices fell 1.2 percent, following a 1.4 percent fall in February. All major categories of crude goods are now significantly below their 1985 levels, except for construction materials.

Housing Starts— Privately owned housing units were started at a seasonally adjusted annual rate of 1,949,000 in March, a decrease of 2.4 percent from the February level. However, at 1.99 million units, total starts during

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**Martin Lefkowitz is director of special projects for the National Chamber Foundation.*

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Feb/86	240.7	240.6	238.1	0.0	1.0
Gross National Product ($B)	I/86	4,116.7	4,059.3	3,917.5	1.4	5.1
Gross National Product (82$B)	I/86	3,619.2	3,590.8	3,547.8	0.8	2.0
Money Supply (M1) ($B)	Mar/86	638.2	631.0	572.2	1.1	11.5
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Mar/86	2,680.8	2,671.5	2,530.2	0.3	5.2
Personal Consumption Expenditures (82$B)	Feb/86	2,357.5	2,337.3	2,297.3	0.9	2.2
Disposable Personal Income ($B)	Mar/86	2,903.6	2,896.2	2,725.1	0.3	6.6
Disposable Personal Income (82$)	Feb/86	2,555.8	2,533.0	2,487.1	0.9	2.8
Personal Savings Rate (%)	Mar/86	4.2	4.3	4.0	−0.1[b]	−0.7[b]
Civilian Employment (millions)	Mar/86	108.8	108.6	107.0	0.1[c]	1.6[c]
Civilian Unemployment Rate (%)	Mar/86	7.2	7.3	7.3	−0.1[b]	−0.1[b]
Average Hourly Earnings	Mar/86	$8.74	$8.71	$8.52	0.3	2.6
Consumer Price Index (All Urban, 67=100) [a]	Mar/86	326.0	327.5	318.7	−0.4	2.3
Purchasing Power of the Dollar (67=$1.00) [a]	Feb/86	0.309	0.308	0.315	0.3	−3.1
Prime Interest Rate (%) April 22, 1986		8.5	9.0	10.5	0.5[b]	−2.0[b]
Retail Sales (B$)	Mar/86	116.6	117.5	111.9	−0.7	4.2
SERVICES SECTOR						
Employment in Services (Millions)	Mar/86	74.7	74.4	71.9	0.4	1.4
Consumer Purchases of Service ($B)	Feb/86	1,375.0	1,358.7	1,283.7	1.1	7.1
Consumer Purchases of Service (82$B)	Jan/86	1,136.6	1,144.8	1,112.9	−0.7	2.1
Domestic Revenue Passenger Mileage Flown - Major Airlines (Billions) [a]	Feb/86	18.9	19.8	16.8	−6.2	12.6
BUSINESS PROFITS AND OUTPUT						
Corporate Profits and Cash Flow ($B) [a]						
Before Tax [a]	IV/85	238.8	228.6	228.0	2.3	2.5
Profits Tax Liability	IV/85	87.1	87.4	87.4	−0.3	−0.3
Tax Liability as a Percent of Profits	IV/85	37.3	38.2	38.3	−0.9[b]	−1.0[b]
After Tax [a]	IV/85	149.5	141.1	140.6	6.0	6.3
Net Cash Flow	IV/85	415.8	404.0	371.6	2.9	11.9
Industrial Production (77=100)	Mar/86	125.1	125.7	124.0	−0.5	0.9
Capacity Utilization Rate (Mfg.) (%)	Mar/86	79.9	80.5	80.4	−0.6[b]	−0.5[b]
New Housing Starts (thou. units)	Mar/86	1,949.0	1,997.0	1,849.0	−2.4	5.4
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77=100)	IV/85	170.5	167.8	163.9	1.6	4.0
Unit Nonlabor Costs (nonfarm) (77=100)	IV/85	158.0	161.4	158.4	−2.1	−0.3
Producer Price Indices (67=100) [d]						
Crude Materials	Feb/86	290.5	301.3	318.9	−5.0	−5.5
Intermediate Goods	Feb/86	317.2	318.8	319.5	−0.4	−0.7
Finished Goods	Feb/86	296.2	297.2	292.1	−0.7	1.4
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67=100)	Feb/86	586.5	616.7	584.5	−4.9	0.3
Federal Government Debt Outstanding ($B) [a]	Jan/86	1,966.8	1,950.3	1,684.4	0.8	16.8
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	I/86	378.4	367.8	379.6	2.9	−0.3
Imports of Goods & Services ($B)	I/86	473.6	481.2	421.9	1.6	12.3
Balance on Goods & Services ($B)	I/86	−95.1	−113.4	−42.3	16.1	124.8
WHAT'S AHEAD?						
Index of Leading Indicators (67=100) [a]	Feb/86	175.4	174.1	167.4	0.7	−4.7

NOTE: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted

[b] Percentage point difference

[c] January data is a new series that is not comparable to previous data

[d] Index number not seasonally adjusted, percent change seasonally adjusted

the first quarter were at their highest level since 1978. Building permits, an indicator of future activity in the home building industry, were 2.4 percent for the month.

Corporate Cash Flow and Profits—Corporate profits have been sluggish for the past year. Profits increased by 2.5 percent between the fourth quarter of 1984 and the fourth quarter of 1985, slower than the rate of inflation, indicating that profit margins are falling. However, corporate cash flow, which includes depreciation allowances, has increased nearly 12 percent over that same period, indicating a strong cash position in the corporate sector.

Industrial Production—Industrial production decreased by 0.5 percent in March, following an 0.7 percent drop in February. The February drop in output was the largest setback in the industrial sector since the recovery began in December, 1982. The industries responsible for the decline were oil drilling, autos and steel whereas the defense and space industry reported an 0.6 percent increase during March, following two months of declines.

The capacity utilization rate in manufacturing decreased to 79.4 percent in March from 80 percent in February. The decline was attributable to a significant drop in auto production. The operating rate for that industry fell from 85.1 percent in February to 75.7 percent in March.

Productivity—Nonfarm business productivity fell 0.2 percent during 1985, the first annual decline since the recession. Business output rose 2.7 percent while hours worked increased 2.8 percent for the year as a whole. Manufacturing productivity rose 2.7 percent in 1985 and output for the manufacturing sector rose by 2.5 percent, while hours worked were down by 0.2 percent.

Interest Rates—The prime interest rate fell to 8.5 percent on April 21, 2.0 percentage points below the rate prevailing at this time last year. The lowering of the prime rate followed a cut in the discount rate by the Federal Reserve from seven percent to 6.5 percent. The prime lending rate is now at the lowest it has been since August 1978. Three- and six-month Treasury bill rates were both below the six percent range on April 22, and thirty-year Treasury bond rates dropped to 7.15 percent, also the lowest level in over eight years.

Federal Spending—The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, increased by 0.3 percent in February compared to its year-ago level. Federal receipts for the first five months of the fiscal year 1986 increased by 5.7 percent, while expenditures for the same period rose by 6.3 percent. The federal deficit for the first five months of fiscal year 1986 was $107.7 billion compared to $99.6 billion during the same period in fiscal year 1985.

Personal Savings—The personal savings rate was 4.2 percent of after-tax income in March, about the same as in the previous month and a little higher than the 4.0 percent reported in March of last year. The low rate of personal savings has been attributed to a number of factors, including the rising stock market that has swelled household balance sheets and left persons with less of a perceived need to save as much from their current income.

Retail Sales—Retail sales declined 0.8 percent in March following a revised 0.1 percentage point increase in February. Sales were 4.2 percent above their year-ago level. Both durable and nondurable goods sales increased 4.1 percent above their March 1985 levels. Part of the March decline was due to lower gasoline prices, which pushed gas station sales down 5.9 percent for the month, and to sluggish auto sales. March retail sales data indicated department and apparel stores registered strong gains, reflecting continued consumer confidence.

Trade Deficit—On a goods and services basis the trade deficit in the first quarter of 1986 was $95 billion, significantly below the $113 billion reported in the fourth quarter of 1985. The $18 billion drop in the trade deficit in the fourth quarter had a significantly positive effect on domestic production. The most encouraging news was that most of the decline was the result of increased exports, indicating that the decline in the value of the dollar is finally beginning to help U.S. firms export their products abroad.

What's Ahead—The composite index of leading indicators, designed to predict future movements in aggregate economic activity, jumped 0.7 percent in February. The January figure was revised to show that the index was unchanged from December. The contributors to the February increase in the leading indicators were contracts and orders for plant and equipment, stock prices, money supply, net business formations and slower deliveries by vendors, indicating a backlog of orders.

WHERE DOES THE FEDERAL DOLLAR GO?

The Department of Commerce recently reported that a total of $788.5 billion in federal money was spent by states and territories during 1985. The report reveals that $349.0 billion was spent in direct payments to individuals, such as Social Security, Medicare, and food stamps; $194.1 billion in procurement contracts for the Defense Department and other agencies; $115.5 billion for federal employee salaries, wages and benefits; $105.5 billion in grants to state and local governments; and $24.5 billion in other expenditures such as research grants and agricultural subsidies.

The per capita federal expenditure for the country as a whole was $3,253. Federal expenditures by state ranged from a low of $2,399 to a high of $4,858. Per capita spending was highest in the following seven states: Alaska, Maryland, Virginia, New Mexico, Missouri, Hawaii and Connecticut.

GROWTH IN REAL GNP

The Federal Reserve Bank of St. Louis recently reported that a reduction in the negative impact of inventory investment (GNP minus real final sales), along with a slight increase in real final sales contributed to the acceleration of real GNP during the second half of 1985. The Fed states that increases in federal purchases of goods and services as well as residential fixed investment contributed towards the growth in real final sales (see table). However, both federal purchases and inventory investment were distorted by relatively large purchases by the Commodity Credit Corporation (CCC). Yet, excluding CCC purchases, federal purchases increased at a much smaller 7.2 percent rate in the second half of 1985 and inventory investment was positive. As the table shows, personal consumption expenditures, nonresidential fixed investment, and the growth of imports pulled final sales down during the second half of 1985.

REAL GNP AND SELECTED COMPONENTS
(compounded annual rates of change)

	II/1985 to IV/1985	II/1984 to II/1985	IV/1982 to II/1984
GNP	2.7%	1.9%	6.9%
Final sales	3.6	3.4	4.3
Personal consumption expenditures	2.2	2.7	5.2
Residential fixed investment	8.5	−0.2	29.2
Nonresidential fixed investment	6.3	10.3	13.6
Government purchases of goods and services	12.5	3.3	1.7
Federal	26.2	3.8	1.2
State and local	2.2	2.9	2.1
Net exports	–	–	–
Exports	1.2	−2.3	6.0
Imports	1.9	0.5	25.7

Source: Federal Reserve Bank of St. Louis

SALES AND INCOME TAXES DOMINATE TOTAL STATE TAX REVENUE

General sales and income taxes account for 70 cents of every tax dollar collected by state governments, the Commerce Department's Bureau of the Census reported recently.

Out of the $214.9 billion collected in state taxes during fiscal year 1985, $150.5 billion came from general sales, personal income, or corporate income taxes. Twenty years ago, taxes generated from these areas accounted for only 47 cents of the tax dollar. The proportion of taxes generated by sales taxes on items such as motor fuel, alcohol, and tobacco dropped significantly, from nearly one-third of the state tax total in 1965 to 16.6 percent in 1985.

DEPARTMENT OF LABOR REPORTS EMPLOYMENT AND EARNINGS CHARACTERISTICS OF FAMILIES

The U.S. Department of Labor's Bureau of Labor Statistics reported that nearly 60 percent of mothers in families with children under 18 were employed during the fourth quarter of 1985. While the total number of families with school or preschool children rose by 460,000 over the year, the number with employed mothers increased by 765,000 to 18.2 million.

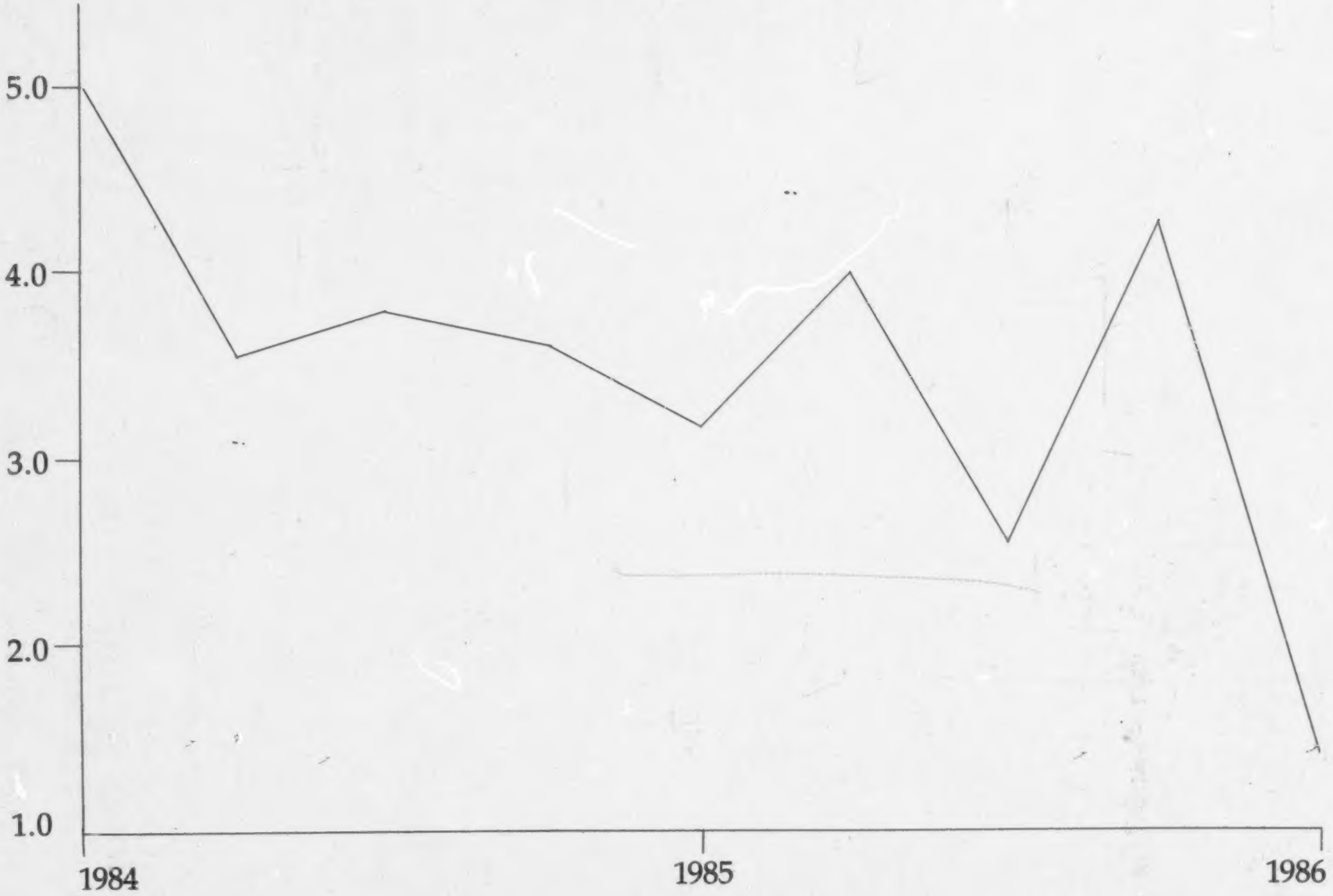
Other fourth-quarter highlights included the following: The total number of families with employed members grew by nearly 600,000 over the year to 50.8 million–81 percent of all families. The number of married-couple families with one employed member increased by 300,000 from a year earlier to 42.1 million. The number of families with unemployed members was virtually unchanged over the year at 5.9 million. Nearly 80 percent of the married-couple families with unemployment also contained an employed member.

COMMERCE DEPARTMENT REPORTS BREAKDOWN OF MANUFACTURING JOBS

During 1983, one out of nine manufacturing jobs was related to the export of manufactured goods, according to the Department of Commerce in its *Annual Survey of Manufactures.* The total number of export-related jobs, 3.9 million, represented 3.7 percent of civilian employment in 1983. The report states that about 2 million export-related jobs were in manufacturing industries, which included 1.1 million in manufacturing plants producing finished goods for direct export, and 900,000 jobs were in affiliated plants and administrative offices furnishing materials and services to exporting plants.

Marked Deceleration in Inflation

(Percent Change)*



*Quarterly percentage change in the consumer price index at a seasonally adjusted annual rate.

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ECONOMIC OUTLOOK

Chamber of Commerce of the United States June/July 1986

TAX REFORM: A GOOD BILL THAT NEEDS IMPROVEMENTS

by
Richard W. Rahn

Last December, President Reagan and some House Republican leaders, including Congressman Jack Kemp, went out on a limb and urged the House to pass a tax reform bill that they themselves would have opposed if it had been the final version of the bill. Reagan and Kemp argued that the Senate would fix the bill. Many, including myself, were skeptical. We were wrong.

The Senate bill is, even in its current form, a major improvement over present law and deserved the support it received. Its chief beneficial aspect is that it will have a positive impact on long-term economic growth, and for that reason, the U.S. Chamber of Commerce endorsed the bill.

However, there is an important caveat. During the first two years after implementation, the bill will have a negative effect on the economy. Four changes need to be made to avoid an economic downturn during the transition period and to make the long-term impact of the bill even more economically constructive than it is now. First, the tax rates should be reduced at the same time as the tax base is broadened; second, the capital gains tax rate needs to be reduced (or at the very least the capital basis needs to be indexed for inflation); third, the minimum tax needs to be reformed; and finally, the investment tax credit should not be repealed retroactively.

In the bill's present form, the reduction in individual tax rates would not be implemented until July 1, 1987, even though the tax base will be broadened effective January 1. Thus, the top individual tax rate for 1987 will be a "blended" rate of 38.5 percent, not 27 percent. This means that taxpayers will experience a large $23 billion tax increase in 1987. This same mistake of phasing in marginal tax rate reductions was made in the Economic Recovery Tax Act of 1981 (ERTA). As a result, the recovery was delayed (and unemployment rose considerably), until July, 1983 when the marginal tax rate cuts were fully effective. In many instances, 1987 tax rates will not be low enough to compensate for the bill's economically damaging tax base changes.

Tables 1 and 2 show the results of two econometric simulations performed to estimate the effect of moving forward the effective date of the cut in individual tax rates and the base broadening. If these provisions were made effective in 1986:3, real economic activity would be $31.7 billion higher over the three years 1986 to 1988. The bulk of the improvement would be in consumer spending; however, residential and nonresidential investment would also benefit, rising by $8.2 billion between 1986 and 1988. The increase in economic activity would lead to the creation of 900,000 new jobs during this period while having no noticeable effect on inflation or interest rates. Obviously, the positive impact on the economy would not be as large if the rate cut and base broadening were implemented simultaneously in January 1987 rather than in July 1986. Nevertheless, the gains would be substantial (see Table 2).

Besides mitigating the positive effects of lower tax rates, the blended rate that will be in effect in 1987 also encourages many taxpayers to delay activities which would result in the production or realization of income until the lower tax rates take effect. The House and Senate conferees should ensure that, in the final version of the tax

IN THIS ISSUE

Tax Reform: A Good Bill That Needs Improvements . . . p. 1
A Sea of Change . . . for the Better . . . p. 3
Forecast Table . . . p. 8
The Money Mystery: Some Clues . . . p. 9
Regional Survey . . . p. 12
Gramm-Rudman-Hollings and the Federal Budget: An Assessment and Outlook . . . p. 19
Trends in Commerce . . . p. 22

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TABLE 1

ECONOMIC IMPACT OF SHIFTING FORWARD THE EFFECTIVE DATE OF THE INDIVIDUAL TAX REFORM MEASURES FROM 1987:3 TO 1986:3

	1986	1987	1988	Cumulative Impact
Real GNP				
Difference[1]	3.3	17.9	10.5	31.7
Percent Difference[2]	0.1	0.5	0.3	
Real Final Sales				
Difference[1]	3.7	18.7	1.8	24.2
Percent Difference[2]	0.1	0.6	0.1	
Consumption				
Difference[1]	4.3	16.2	8.1	28.6
Percent Difference[2]	0.2	0.7	0.3	
Nonresidential Investment				
Difference[1]	0.4	2.7	2.4	5.5
Percent Difference[2]	0.1	0.6	0.5	
Equipment				
Difference[1]	0.3	2.1	1.8	4.2
Percent Difference[2]	0.1	0.7	0.6	
Structures				
Difference[1]	0.1	0.8	0.7	1.6
Percent Difference[2]	0.1	0.5	0.4	
Residential Investment				
Difference[1]	-0.6	1.3	2.1	2.8
Percent Difference[2]	-0.3	0.7	1.2	
Industrial Production Index				
Difference[3]	0.1	0.9	0.5	
Percent Difference[2]	0.1	0.6	0.4	
Civilian Employment				
Difference[4]	0.3	0.4	0.3	0.9
Percent Difference[2]	0.2	0.4	0.2	
Consumer Price Index				
Difference[3]	0.06	-0.01	-0.03	
Percent Difference[2]	0.02	.00	-0.01	
3-mos. Treasury Bill Rate				
Difference[5]	0.01	0.05	0.05	
Corporate Bond Rate				
Difference[5]	-0.02	0.00	0.05	

(1) Difference from base in billions of 1982 dollars.
(2) Percent difference from base.
(3) Difference from base in index points.
(4) Difference from base in millions of jobs.
(5) Difference from base in percentage points.

Source: U.S. Chamber of Commerce, Forecasting Section, using the Washington University Macroeconometric Model of the U.S. economy. The base case contains the changes in tax rates and tax revenues as per the Senate Finance Committee's bill. The alternative case moves the effective date of the individual rate cut and base broadening to 1986:3 instead of 1987:3.

reform bill, base broadening and tax rate reductions take effect on the same date.

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Ms. Rajni Bonnie Ohri, Economist.

TABLE 2

ECONOMIC IMPACT OF SHIFTING FORWARD THE EFFECTIVE DATE OF THE INDIVIDUAL TAX REFORM MEASURES FROM 1987:3 TO 1987:1

	1986	1987	1988	Cumulative Impact
Real GNP				
Difference[1]	0.0	10.7	8.3	19.0
Percent Difference[2]	0.0	0.3	0.2	
Real Final Sales				
Difference[1]	0.0	11.3	-1.8	9.5
Percent Difference[2]	0.0	0.3	-0.1	
Consumption				
Difference[1]	0.0	10.5	5.4	15.8
Percent Difference[2]	0.0	0.4	0.2	
Nonresidential Investment				
Difference[1]	0.0	1.7	2.0	3.7
Percent Difference[2]	0.0	0.4	0.4	
Equipment				
Difference[1]	0.0	1.3	1.5	2.7
Percent Difference[2]	0.0	0.4	0.5	
Structures				
Difference[1]	0.0	0.4	0.5	1.0
Percent Difference[2]	0.0	0.3	0.3	
Residential Investment				
Difference[1]	0.0	0.1	1.6	1.7
Percent Difference[2]	0.0	0.1	0.9	
Industrial Production Index				
Difference[3]	0.0	0.5	0.4	
Percent Difference[2]	0.0	0.4	0.3	
Civilian Employment				
Difference[4]	0.0	0.3	0.2	0.5
Percent Difference[2]	0.0	0.3	0.1	
Consumer Price Index				
Difference[3]	0.00	0.06	0.04	
Percent Difference[2]	0.00	0.02	0.01	
3-mos. Treasury Bill Rate				
Difference[5]	0.00	0.05	0.03	
Corporate Bond Rate				
Difference[5]	0.00	0.01	0.02	

(1) Difference from base in billions of 1982 dollars.
(2) Percent difference from base.
(3) Difference from base in index points.
(4) Difference from base in millions of jobs.
(5) Difference from base in percentage points.

Source: U.S. Chamber of Commerce, Forecasting Section, using the Washington University Macroeconometric Model of the U.S. economy. The base case contains the changes in tax rates and tax revenues as per the Senate Finance Committee's bill. The alternative case moves the effective date of the individual rate cut and base broadening to 1987:1 instead of 1987:3.

Raising the capital gains tax rate from 20 percent to 27 percent will have an adverse impact on the ability of small businesses to raise equity capital because it will reduce the willingness of venture capitalists to take the risks involved in funding innovation and technological research. Higher capital gains tax rates reduce the liquidity and efficiency of capital markets. Moreover, higher capital gains tax rates reduce taxpayers' willingness to actually realize capital gains, thus reducing the amount of tax revenue that the federal government actually receives. Experience shows us that following the cuts in the capital gains tax rate implemented in 1978 and 1981, revenues actually rose. This flaw in the bill could be repaired easily, either by retaining the existing 20 percent tax rate or, at a minimum, indexing the capital basis for inflation.

Two changes need to be made in the proposal's corporate minimum tax provisions. Although the subject is distressingly complex, the amount of revenue and the principles at stake are important enough to warrant widespread discussion. (Also, the proposed minimum tax is so comprehensive that we estimate that as many as one-third of the businesses in the United States would regularly pay taxes under the minimum tax).

The capital consumption system used for the minimum tax employs very long pre-1981 recovery lives under the straight-line method of depreciation. Thus, much of the needed improvements in the capital cost recovery system used for regular tax purposes will, in effect, be taken away by the minimum tax. In its present form, the minimum tax would raise the cost of capital, reduce investment and harm economic growth. The solution is to use the same lives for minimum tax purposes as for regular tax purposes and to simply include the amount attributable to acceleration in the minimum tax base. The Senate proposal would also include one half of "book" income in the minimum tax base to the the extent that it exceeds alternative minimum taxable income. Book income is an imprecise term which can mean accounting statements filed with the Securities and Exchange Commission, other certified financial statements used for credit or other purposes, or even unaudited statements of privately held firms generated for their own internal use. This provision will place tremendous pressure on the accountant-client relationship and the integrity of financial statements. Businesses, especially closely-held businesses, will be under financial pressure to hire accountants who tend to minimize their book income. U.S. financial accounting statements are the envy of the world. Their integrity is accepted because there is no tax-motivated manipulation of financial statements as is the case in some other countries.

Both the House and Senate bills repeal the investment tax credit retroactively to January 1 of this year. It is very hard to justify this effective date on any grounds. It is a pure revenue grab! Because businesses will have no compensating rate reductions or capital cost recovery changes, investment in 1986 has become dramatically less attractive than before tax reform. Thus, we expect investment to have already slowed in 1986 and economic growth, therefore, will be relatively sluggish for at least one year.

According to estimates by the Congressional Budget Office (CBO), the changes that we have suggested will cost, on a static basis, $63.6 billion over a five year period. As a result of both the uncertainty over the tax treatment of capital investment and the effective increase in taxes over this year and next, our estimate is that the rate of growth in the nation's gross national product (GNP) will be 1.7 percentage points lower over the next twelve months than it would if we immediately cut tax rates and broadened the tax base. This reduction in potential GNP will increase the federal deficit by $7 to $10 billion over the next twelve months alone, and even more in the future as it permanently lowers the revenue base. In contrast, the shortfall that might emerge from a speed-up in the date of enactment for tax rate reduction would be a one-time loss and would be quickly offset by the higher revenues that follow from faster economic growth. Thus, if policymakers viewed the suggested changes in their proper, dynamic sense, rather than in a naive, static sense, it would be obvious that the deficit would be lower in each of the next five years by adopting our proposed changes now.

The uncertainty surrounding taxes has already had a negative effect. Taxpayers who might be hurt by the myriad of tax reform proposals assume that they will, in fact, be hurt and, as a result, do not invest. Taxpayers who might benefit from the various proposals assume that they will not get those benefits and, as a result, also do not invest. Thus, investment and other economic activity decline. A recent survey of U.S. Chamber members found that 42 percent have delayed or canceled investment plans because of the uncertainty surrounding tax reform.

Other surveys of capital spending, both private and public, show that real investment spending this year is going to be woefully weak. If the House-Senate conference makes the recommended changes, we will have achieved tax reform that promotes long run economic growth with relatively small transitional costs.

A SEA OF CHANGE... FOR THE BETTER

by
Graciela Testa-Ortiz

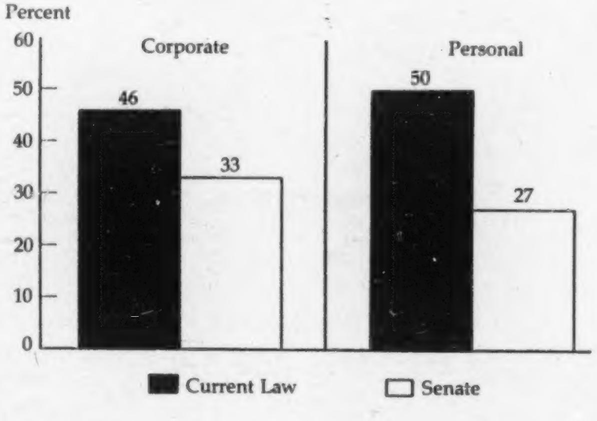
The United States is firmly in the midst of twin transitions: A change in public policy objectives characterized by a general realization of the benefits of supply-side/free market economic policies, as reflected in the current tax reform debate; and, a significant shift in the economy's structure as characterized by the effect of technological innovation and world trade patterns on the production process. These developments are not unique to the United States or even to the developed economies; indeed, they have global dimensions. This article examines these two trends and their implications for U.S. public policy and the economic outlook.

The Supply-Side/Free Market Revolution Goes Global

In the past, we have stressed the importance of certain policy prescriptions which we call our "High Growth Agenda." Central to that agenda was the notion that a modest level of taxation and low marginal tax rates are a prerequisite for high rates of growth and rising living standards. Six years ago, when these supply-side policies were first introduced, they were greeted with widespread skepticism. Today, however, large segments of the academic, political and business communities agree that lower tax rates are, indeed, needed to foster stronger rates of economic growth.

Ironically, while today few economists and politicians admit to being supply-siders, they all support the essence of supply-side policies, as the competing tax reform proposals now make clear. The debate surrounding tax reform is about how these reductions in tax rates will be achieved, not about whether or not they are desirable. The desirability of tax rate reductions is no longer questioned (see Chart 1).

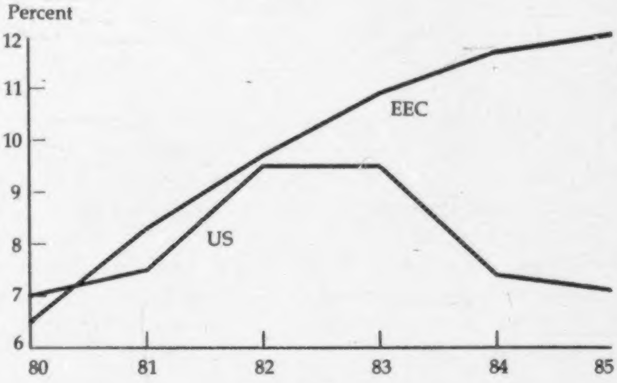
CHART 1
PERSONAL & CORPORATE TAX RATES



Taxes, of course, are important, but the supply-side/free market revolution goes well beyond this single focus. To insure economic vitality, low levels of taxation must go hand in hand with reductions in the level of government intrusion in the economy. The enactment of the Gramm-Rudman balanced budget act is an important step in this direction. Perhaps more than anything else, it reflects the consensus in this country that the size of the federal government must be reduced. The absence of any new major regulations or new spending programs should be interpreted as reflecting the desire of Americans for less government. Beyond these policy issues, however, there is today a new appreciation of the free market as an engine of growth and prosperity as well as an appreciation of the general benefits accruing from capitalistic acts between consenting adults.

Americans are not the only ones who have rediscovered the wisdom of such policies. The free market policies that we have supported as a solution for the stagnation of the 1970s are now gaining wider acceptance abroad, as well. With the exception of modest changes in Great Britain, no other European nation embraced supply-side prescriptions early in the decade. Over the past several years, as the American economy created millions of private sector jobs, unemployment in Europe rose (see Chart 2) and GNP growth remained woefully weak. This weakness was often in direct proportion to how far each had drifted from free market, limited government policies. Today, most nations are slowly instituting the policies which proved to be so successful in the United States and elsewhere, and few now publicly admit to harboring socialist tendencies.

CHART 2
UNEMPLOYMENT RATES
US VS. EEC



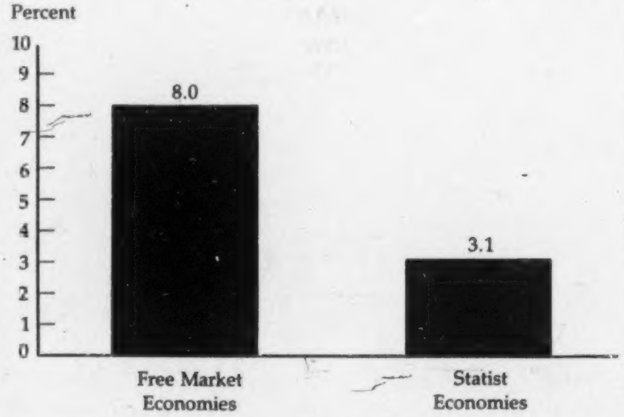
This recognition of the importance of incentives to productive activity is not confined to the developed nations or the market economies. Many of the East Asian nations, which started out the postwar era classified among the poorest nations of the world, have enjoyed dramatic increases in income and production as a result of the free market policies which they adopted.

The growing acceptance of free-market/limited government solutions to the problems of economic growth, job creation and the alleviation of poverty is particularly encouraging in the case of Latin America, a region which, heretofore, had, almost without exception, wholeheartedly embraced the notion that the only correct development strategy was the encouragement of statist policies revolving around import-substituting industries protected behind high tariff walls. Encouraging Latin American examples of this shift in development strategies are the policies enacted by the governments of Ecuador and Bolivia.

In some respects, the postwar era can be viewed as a unique social science experiment of worldwide dimensions. As new governments were established in the early postwar era, their leaders had a variety of political/economic systems from which to choose. Some opted for socialism, others for capitalism, while still others chose a mixture, opting for significant government planning in their economies. Now, three decades later, we have their records of performance to observe and analyze. In virtually all cases, we typically find that the low tax, limited government, free market nations substantially outperformed their counterparts who elected to follow the alternative paths (see Chart 3).

CHART 3

REAL GDP GROWTH RATE
1973-1983



On the left side of Table 1, the industrial nations are ranked according to the share of income taken by the government. On the right side are the same nations ranked according to industrial production growth. Not surprisingly, the right side of the table shows the countries listed in exactly the inverse order of the left side of the table. This shows that the countries with lower tax burdens enjoyed the best industrial performance.

TABLE 1

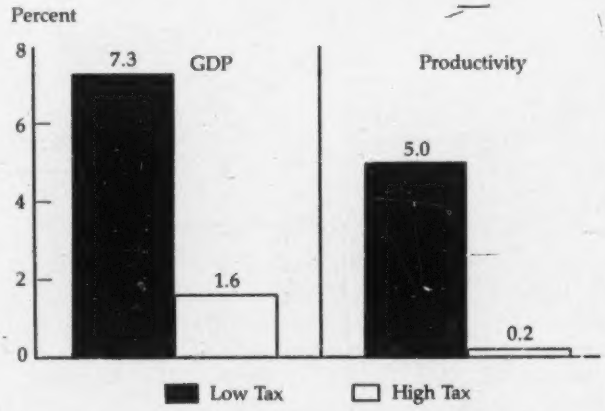
TAX BURDENS AND INDUSTRIAL PRODUCTION IN DEVELOPED COUNTRIES

Tax Burdens	1983 Receipts as a % of GNP	Industrial Production	Percent Change (1980-1984)
France	47.7%	Japan	16.5%
West Germany	45.2	United States	12.1
United Kingdom	42.4	United Kingdom	3.1
United States	31.7	France	0.0
Japan	29.8	West Germany	-0.7

This relationship is not confined to just the industrial economies. Chart 4 is derived from a World Bank study which catalogued countries according to whether they had low or high tax rates. By both measures—GDP and labor productivity—the low tax countries significantly outperformed the high tax countries. Not coincidentally, the high tax nations are counted among the world's problem debtors.

CHART 4

GDP AND PRODUCTIVITY GROWTH IN LOW TAX AND HIGH TAX LDCs

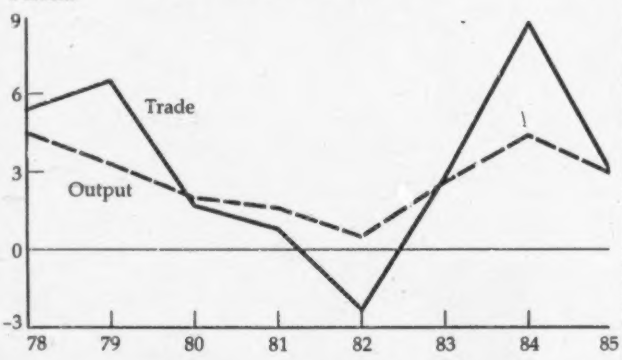


American business should be very concerned with international growth prospects, and in particular, it should strongly support the movement toward free-market alternatives to economic development. Why? The reasons are not just altruistic, although that in itself is compelling enough. We certainly can't be complacent about an outcome where annual per capita income in Bangladesh is equivalent to the price of a tune-up and oil change of a car in the United States. But beyond these altruistic motives is self-interest. Quite simply, the developing nations represent an enormous market for U.S. exports and investment. In 1984, the developing nations, including the newly industrializing countries of East Asia, accounted for 32 percent of U.S. exports of manufactures, down from 39 percent in 1981. This demand for American products was generated in the midst of the debt crisis, when most LDCs—but particularly the Latin American LDCs—were drastically reducing imports in order to meet their debt obligations. In today's interdependent world economy, how much more important would they be, as customers, if their economies were growing instead of shrinking?

History shows us that world trade and world output generally move together, that is, when the volume of world trade is increasing, so is world output (see Chart 5). History is replete with examples of countries who have traded their way to wealth, and the East Asian countries are the most recent example. Americans should pay particular attention to this experience and resist the enactment of protectionist policies which can only harm our prospects for long term economic growth.

CHART 5

ANNUAL GROWTH RATES IN WORLD TRADE AND OUTPUT



Shifts in the Structure of the Economy

The shifts in the economy's structure are best exemplified by the change in the relationship between industrial performance and industrial employment. In the past, these two variables moved in unison, that is, as industrial production rose, so did industrial employment. This does not appear to be the case any longer. The U.S. economy, and indeed, the world economy, is going through a period of transition which, when all is said and done, may parallel the changes brought about by the Industrial Revolution.

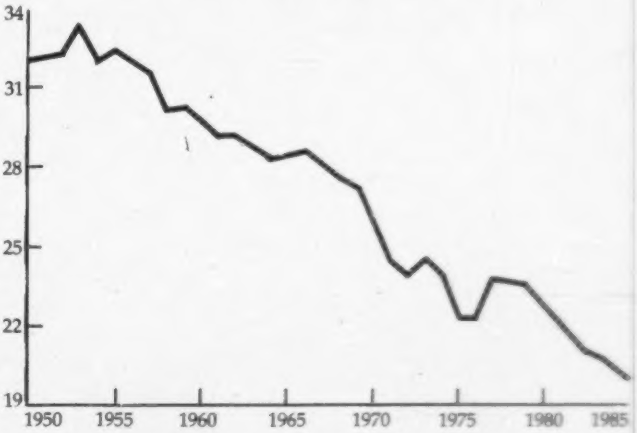
As we explained in our industrial outlook (see the November 1985 issue of Economic Outlook): "This process is by no means a negative development...An economy that can adjust successfully to changing technology, consumer tastes, and global economic conditions is a healthy, growing economy whose industries can compete effectively both at home and abroad." Decision-makers in the public as well as private sector should understand that this inevitable transition is already well underway. The future of the U.S. economy as a whole, as well as that of the individual industries and firms, depends on the implementation of the types of policies that will facilitate this process of adjustment, not delay it.

The primary mover behind these changing economic conditions is the impact of innovation and new technologies on the production process. Some worry that, as a result of these technological improvements, many jobs will be lost in the manufacturing sector. In fact, the increase in employment in the service industries and the decline in the proportion of manufacturing in total employment is seen by some as an alarming development which implies declining living standards. They point out that high-wage manufacturing jobs are being lost while employment gains are being realized in lower wage service sector jobs.

The decline in manufacturing as a source of employment is nothing new; as Chart 6 shows, it began several decades ago. Moreover, this same trend is apparent in all industrialized countries. Increases in industrial production no longer mean concomitant increases in employment in the industrial sector. While industrial production increased by 14.7 percent between 1980 and 1985, manufacturing employment in 1985 was still 1.2 million jobs below its 1980 level.

CHART 6

MANUFACTURING EMPLOYMENT AS A PERCENT OF TOTAL EMPLOYMENT



Is the shift toward a service-producing economy a negative development? Should public policy be geared toward preserving manufacturing jobs? The answer to both questions is no. Research by the Bureau of Labor Statistics (BLS) shows that the concern with the impact on living standards of the shift to the service sector as a source of jobs is misplaced. In particular, the evidence does not support the view of a shift from high-wage to low-wage jobs. This notion stems from the commonly held view that service sector jobs are low skilled, mainly part-time, dead-end jobs which pay little more than the legal minimum wage. This ignores the fact that the service sector includes jobs other than those found in eating and drinking establishments and retail stores. The service sector also includes firms in finance, insurance, real estate, advertising, computer services, legal services, communications and a host of other industries whose wage levels are significantly higher than the minimum wage. Before bemoaning the jobs lost to automation, one must remember that before a robot can be installed it has to be designed, tested, and built; and once it is in operation, it requires highly-skilled people to program and service it. Beyond this, the BLS study reminds us, "we should not forget that efficiencies related to technological innovation may change the relative prices of goods and services, increase product demand, and free resources for investment or for the purchase of goods in other sectors."

Another concern raised by the shift to service-sector employment is the fear that lower productivity in this sector will reduce overall productivity in the U.S. economy. As a result of increases in capital investment, labor productivity in the manufacturing sector has risen at rates exceeding those of most earlier recovery periods. The improvement is even more impressive in durable goods manufacturing. Moreover, this has occurred in spite of the fact that capacity utilization remains relatively low. As a result, unit labor costs in the manufacturing sector actually declined during this recovery, the second time this has happened in the seven postwar recoveries. However, it is not true that productivity in the service industries is uniformly lower than in manufacturing. The BLS study points out that between 1973 and 1983, the increase in labor productivity in such service industries as telephone communications, gasoline service stations and air transportation, ranged between 3.3 percent to 6.5 percent per year. In general, the study concludes, "the range of growth rates in service-producing industries was very wide and similar to that of the goods-producing industries."

When one speaks of technological innovations, robots are the first thing that springs to mind. But the impact of new technologies is not limited to the industrial process. New technologies have revolutionized the farm economy through their impact on high-yield hybrids, fertilizers, and pest control, as well as their more traditional impact on improved farm machinery. As a result, the global supply of agricultural products now far exceeds the demand. Not long ago studies such as the *Global 2000* report to President Carter and *The Limits to Growth* by the Club of Rome, asserted that by now, the relationship would be reversed; that is, that the supply of food would not be capable of keeping pace with expanding demand.

Over the same period, most nations have engaged in substantial efforts to raise farm production. As a result, of the industrialized nations, only Japan is still a major importer of food. The developing nations have been even more successful than the U.S. or the European Community in increasing food production.

The same has happened with other basic raw materials. Technological advances have now made substitutes available for basic raw materials such as copper and steel. The substitution of plastic tubing for copper in construction, or fiberglass cable for copper wire in telecommunications, or the decline in the amount of steel necessary to produce an automobile, are prime examples. Consequently, most basic raw materials are in oversupply and commodity prices have reached historic lows. The falloff in the price of oil, in part, also reflects the impact of new technologies which have resulted in the introduction of machines, such as the heat pump or fuel-efficient automobiles, which permanently reduced the demand for petroleum. Thus, the decline in the price of commodities will not be reversed since it stems from a decline in demand which will not be reversed. For evidence, consider that despite the global economic recovery, commodity prices and the proportion of manufacturing jobs in total employment have remained low. In fact, between 1981 and 1985, U.S. demand for petroleum fell by 2 percent, in spite of the fact that real GNP increased by 11 percent and crude oil prices fell by 35 percent over the period. Moreover, manufacturing employment fell to 19.9 percent of total employment in 1985, compared to 22.8 percent in 1980, while industrial production increased.

The Twin Transitions

It is important to realize that these technological innovations, which have altered the face of the production process and have resulted in the introduction of a multitude of new products and services would not have occurred in the absence of free markets. Moreover, the increased importance of free market mechanisms, and the erosion of the fiscal and regulatory impediments to the free interplay of market forces holds the promise of a renewed unleashing of entrepreneurial vigor.

The conclusions that should be drawn from this evidence are that: (1) future increases in industrial production are unlikely to be accompanied by major improvements in industrial employment or raw material prices; (2) that this trend does not imply declining wages, productivity, or employment for the economy as a whole; (3) that, in fact, it will result in a better allocation of resources, the introduction of new products and services, and a healthier overall economy; and, (4) that public policy should not delay the process of adjustment in an attempt to preserve industrial sector jobs.

The Near Term Outlook

The economy's performance during the next two years will be shaped mainly by tax reform. While the Senate's proposal represents an improvement over the House version, it, nonetheless, contains some provisions which will burden U.S. businesses with additional taxes. In particular, the Senate tax bill will increase the taxation of capital gains and the corporate minimum tax, and repeal the investment tax credit retroactively. The timing problem is particularly important since it is likely to depress growth in 1986 and early 1987. Since the Senate bill offers improved depreciation in 1987, plus a lower tax rate, why would any business take delivery of nonessential capital equipment in 1986?

TABLE I
UNITED STATES ECONOMIC OUTLOOK 1986-1987
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates.)

	QUARTERS										YEARS		
	Actual			Forecast							Actual	Forecast	
	85:3	85:4	86:1	86:2	86:3	86:4	87:1	87:2	87:3	87:4	1985	1986	1987
GROSS NATIONAL PRODUCT													
Real GNP	3.0	0.7	2.9	2.0	4.9	4.4	3.2	3.6	4.6	5.4	2.2	2.6	4.0
Consumption	4.6	0.1	3.8	4.7	3.5	2.2	1.8	2.0	2.9	4.4	3.3	3.2	2.6
Residential Investment	8.5	5.7	9.7	9.8	-1.9	-5.4	-5.6	-2.7	1.6	2.4	1.7	6.1	-2.3
Nonresidential Investment	2.4	11.3	-13.3	1.6	4.5	5.3	1.9	1.5	7.1	4.8	9.7	0.6	3.6
Equipment	3.0	13.5	-12.1	2.8	5.5	5.7	1.4	0.4	8.0	4.2	8.8	2.0	3.6
Structures	1.2	7.2	-15.4	-0.7	2.7	4.6	2.8	3.7	5.4	5.9	11.4	-1.9	3.6
Exports	-5.1	6.6	6.6	12.0	12.7	13.2	13.1	13.5	13.5	13.5	-3.0	6.0	13.2
Real Net Exports (82$B)	-119.8	-140.8	-138.1	-129.8	-119.0	-107.4	-93.2	-78.1	-64.5	-53.3	-108.4	-123.6	-72.3
Imports	12.8	24.5	2.4	1.9	0.4	0.5	-1.3	-1.5	0.1	2.3	2.7	7.9	-0.2
Government Purchases	37.3	23.4	-30.1	-5.0	2.3	2.0	1.2	1.0	0.5	0.1	10.3	-1.6	0.9
Final Sales	5.0	1.3	-1.7	4.5	4.2	3.3	2.9	3.2	4.5	4.9	3.9	2.1	3.6
Change in Business Inventories (82$B)	-1.8	-6.3	35.3	13.6	19.6	29.5	32.4	36.8	38.6	43.5	5.7	24.5	37.8
Industrial Production	3.1	2.0	2.3	-2.5	8.7	8.0	4.8	5.9	8.1	9.0	2.6	2.5	6.3
Total New Car Sales (mill.)	12.4	10.3	11.0	11.0	11.0	11.0	11.2	11.3	11.5	11.9	11.2	11.1	11.5
Domestic Car Sales (mill.)	9.4	7.0	7.9	7.8	7.9	8.1	8.3	8.3	8.5	8.9	8.3	7.9	8.5
New Housing Starts (mill.)	1.69	1.77	1.99	1.95	1.87	1.83	1.71	1.73	1.75	1.76	1.74	1.91	1.74
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	7.2	7.0	7.1	7.1	7.1	6.9	7.0	7.0	6.8	6.5	7.2	7.1	6.8
Compensation	3.0	3.2	2.0	2.9	3.0	3.2	4.1	3.4	3.6	3.7	3.7	2.9	3.5
Productivity	0.4	-4.1	3.5	0.0	2.8	1.9	1.1	1.6	1.9	2.1	-0.2	0.6	1.7
Unit Labor Costs	2.6	7.7	-1.4	2.9	0.2	1.2	2.9	1.7	1.6	1.5	4.3	0.7	2.0
Consumer Price Index	2.4	4.4	1.4	-2.0	2.0	2.8	2.9	2.8	2.9	2.9	3.5	1.8	2.6
Implicit GNP Deflator	2.9	3.3	2.9	1.9	2.6	2.2	2.3	2.6	2.6	2.8	3.3	2.7	2.4
Prime Interest Rate (%)	9.5	9.5	9.4	8.5	8.3	8.0	8.0	7.8	7.6	7.5	9.9	8.5	7.7
3-mos. Treasury Bill Rate (%)	7.1	7.2	7.0	6.2	6.0	5.9	5.7	5.5	5.6	5.9	7.5	6.3	5.7
Corporate Bond Rate (%)	11.0	10.6	9.6	9.3	9.0	8.8	8.4	8.0	8.0	7.8	11.4	9.2	8.1
Real Personal Disposable Income	-4.6	2.2	5.7	2.5	1.0	1.7	2.8	1.3	1.8	6.1	1.4	2.4	2.2
Profits from Current Production ($B)[1]	221.7	216.0	234.0	217.2	228.6	229.7	231.7	240.1	250.0	278.5	210.5	227.4	250.1
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts											736	778	846.9
Unified Outlays											937	988	1013
Unified Deficit											-201	-210	-166.1

[1] After-tax corporate profits with inventory valuation and capital consumption allowances.

[2] Unified budget figures on a fiscal year basis.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's outlook contains the June revisions to the National Income Accounts for the first quarter of 1986. The forecast incorporates provisions of the Senate's plan for tax reform. These include: reductions in personal and corporate marginal income tax rates, repeal of the ITC, less generous depreciation allowances for structures, and elimination of the preferential treatment of capital gains income. These changes are implemented consistent with the static revenue estimates reported by the Joint Committee on Taxation. The nation's money supply (M1) is assumed to grow by 11.9 percent in 1986, 10.6 percent in 1987, and 8.4 percent in 1988. The trade weighted exchange value of the dollar falls by 9.6 percent in 1986, 5.3 percent in 1987, and 1.9 percent in 1988. The price of imported oil averages $15.00 per barrel. The federal minimum wage is not expected to increase.

This month we have performed alternative simulations to show the negative impact of this timing problem. In 1987, individuals will lose their deductions effective January 1; but the reduction in tax rates does not go into effect until July 1, 1987. The result is that at least some individuals may actually experience a tax increase next year. We should have learned these lessons in 1981 when the individual tax rate reductions, enacted in 1981, did not go fully into effect until 1983. This delay contributed to the severity of the 1982 recession. Five years later, the pending enactment of a tax reform bill with the same type of timing problems could lead to the same results.

As a result of the potentially depressing initial effects of tax reform, we expect real GNP to rise by 2.6 percent this year. The beneficial effects of lower oil prices, which should be felt toward year-end, are likely to be offset considerably by reduced investment spending due to tax reform considerations. Growth should be somewhat stronger in 1987 as the transition to lower tax rates is completed and the economy continues to benefit from low inflation, falling interest rates, and a lower-valued dollar.

We remain optimistic with respect to the prospects for inflation. We believe that the concern regarding an acceleration of inflationary pressures stemming from rising prices in the services industries is misplaced. Empirical evidence shows that wholesale prices of raw and semifabricated materials, not services, are a leading indicator of future inflation. Not only are commodity prices at a historical low, but, as explained above, they are unlikely to rise substantially. This evidence, together with other factors such as still modest wage pressures, very low rates of capacity utilization, and productivity increases, provide a powerful argument for a low inflation scenario, despite the upward pressure that may stem from higher-priced imports.

Thus, barring the near-term weakness that we foresee stemming from tax reform considerations, the outlook for the American economy is, indeed, optimistic.

THE MONEY MYSTERY: SOME CLUES

by
Ronald D. Utt

Over the last year or so, the basic tenets of monetarism, which argue that there is a reasonably stable and predictable relationship between growth in the money supply and growth in nominal gross national product (GNP) have fallen from favor as both an explanation of macroeconomic phenomena and as a guide to Federal Reserve policy. In large part this disfavor follows from an apparent breakdown in the heretofore predictable relationship between money and nominal GNP, as well as the latter's component parts: real economic activity and inflation.

Monetarists have long argued, and the historical evidence generally supports their argument, that the economy's demand for money follows a stable and predictable pattern, and that this stability enables one to predict, with reasonable certainty, the impact of a change in the money supply on nominal income, and thus, on its component parts – the price level and real economic activity. Typically, an increase in the money supply above its trend rate of growth leads to a comparable increase in nominal GNP, first through an increase in real economic activity and then through inflation, with the whole process generally taking about 24 months to run its course.

Since early 1984, however, this relationship appears to have fallen apart as the money supply (measured by M1 – the sum of cash, demand deposits and NOW accounts) has continued to advance at a rapid clip while growth in real GNP and inflation have slowed substantially. At first, in late 1984, this was viewed as just a temporary aberration that would quickly rectify itself, but as the months went by, and as 1985 gave way to 1986, it became apparent that the slowing in both the economy and the rate of inflation were becoming even more pronounced while the money supply continued to increase at accelerating rates.

Beginning in late 1984, for example, growth in the money supply increased at double-digit rates and continued at those rates for all of 1985. In 1985, M1 increased by 11.9 percent and has been running at even higher rates of growth through the first part of 1986. At 11.9 percent, money growth in 1985 was the highest in the postwar era, and well above the 8 percent rates of growth in the late 1970s which contributed to the accelerating inflation and financial instability at the end of that decade. But, in 1985, such rapid rates of money growth seemingly had no apparent impact on either inflation or economic growth. Indeed, both measures actually declined from their rates of increase experienced in 1984, and have continued to slow even further in 1986. Real GNP growth in 1985 was only 2.2 percent compared to 6.5 percent the previous year, while the implicit price deflator fell to 3.3 percent from 4.1 percent in 1984. And over the same period, industrial production scarcely advanced at all.

This breakdown in the relationship between money and nominal GNP has contributed to a rather lackluster performance for the forecasting profession over the past year or so. At the outset of 1985, the consensus forecast was for 3.3 percent real GNP growth that year, and this was increased to 3.9 percent by March. Likewise, inflation was expected to rise somewhat faster from its 1984 rate of advance. Instead, real GNP growth struggled along, while the rate of inflation slowed. As poorly as the consensus forecast was, the forecasts by monetarists were even worse. Many had predicted robust growth and rising inflation, with some estimates of the price increase going as high as 8 percent in 1985. The Chamber was not immune to this view, and, thus, actual experience fell well short of our forecast.

Obviously, there were some extenuating circumstances that can explain these inaccurate forecasts: The rising value of the dollar helped keep the economy and inflation in check, while the threat of a hostile tax bill deterred some capital investment, and the collapse of oil prices contributed to further moderation in inflation. Nonetheless, a careful review of these factors suggests that they merely contributed to trends that were already evident. Moreover, as suggested later in this article, these special factors, too, may have been the outcome rather than the contributors to the rather unusual relationship between money and everything else that emerged in recent years.

As is usually the case, the economics profession has rushed forth with a host of competing explanations for what happened since 1984. With monetarism seemingly in retreat after reaching an intellectual high-water mark at the beginning of the decade, these explanations fall into two basic schools: Those who want to drive the final nails into the coffin of M1 and its monetarist supporters, and those who want to resurrect the tenets of the discipline by attempting to interpret more accurately what happened during the last several years.

Those who have never been comfortable with the monetarist belief in a stable relationship between M1 and nominal income (which follows from a stable and predictable demand for money), see the events of the last year or two as confirmation of their skepticism and point to the sharp deceleration in the velocity of money as proof. If the demand for money were stable or changed in a stable, predictable fashion, then velocity (the ratio of GNP to M1) should be stable and predictable as well. Between the end of World War II and 1981, such stability appeared to be the rule. Velocity increased at a consistent pace year after year, reflecting steady declines in the demand for money that followed from technological changes in the financial system which allowed businesses and individuals to spend more while holding less money. Such things as sweep accounts and credit cards diminished the demand for cash and demand deposits. Since 1981, however, velocity has been declining at about 2 percent per year. This reversal of velocity growth and its duration is unprecedented in the postwar era.

A decline in velocity is, of course, equivalent to an increase in the demand for money. And with the demand for money thus subject to unpredictable changes in either direction, predictions based on changes in the money supply become problematic.

What could have disrupted what had heretofore been viewed as a highly stable relationship? Opponents of monetarism argue that the sharp decline in inflation since 1981 encouraged individuals and businesses to hold more cash and demand deposits for a given level of transactions. In the years prior to 1981, when inflation worsened year after year, successive increases in the price level led to the depreciation of money. To avoid this, businesses and individuals were encouraged to economize on cash holdings by putting more of their liquid wealth into interest-earning financial assets in an effort to limit this depreciation.

But once inflation decelerated, such defensive precautions became unnecessary and their costs outweighed their benefits. As a consequence, the economy's demand for money rose and increases in the supply were quickly absorbed by businesses and individuals anxious to increase their holdings of money in order to save on the transactions costs that are incurred in making frequent switches between money and highly liquid assets such as Treasury bills. Inasmuch as the period from 1981 to the present has been characterized by a declining rate of inflation and a diminution of inflationary expectations, this is a reasonable explanation of what has happened.

Acceptance of this explanation, then, raises very real questions about the predictive capability of monetarism and monetarists' prescriptions for Federal Reserve Policy. If money demand is not stable, then neither is the relationship between money and income. Under these circumstances, the Fed cannot have much confidence in the impact of its policies unless it finds some other economic variable in addition to M1 to guide its actions. If society wishes to hold more money and the Fed does not accommodate this change, then monetary policy will be too restrictive and the economy will suffer accordingly. Growth in income will be slow, real interest rates and the exchange rate will be high and sensitive commodity prices will decline. Inasmuch as all of these events have occurred at one point or another over the past several years, public policy officials and economists have become increasingly disenchanted with the monetarist prescription which they so willingly embraced at the beginning of the decade.

Although monetarism is in retreat, its opponents contend that vestiges of those beliefs still guide Fed and Administration policy, and that a reluctance to be free of the notion altogether has contributed to today's lackluster economy. The Fed, for example, still formally attempts to meet M1 targets and although it has regularly exceeded them over the past several years, opponents argue that this excess has fallen well short of the increase in the demand for money. Thus, they argue that monetary growth is still too restrictive despite the double-digit rates of increase in M1 over the past year or so. These opponents further argue that the Fed should give up on M1 targeting altogether and instead attempt to stabilize commodity prices. That way it would not have to guess what the economy's demand for money was at any point in time, but would still be able to support noninflationary economic growth. If prices fell, then money would be deemed too tight and further increases in the money supply would be appropriate. If prices increased, money would be deemed too loose and some restraint would be required.

In response to these criticisms, some monetarists defend the basic principles of the discipline by noting that it is the definition of money (M1) that is the problem, not monetarism per se. They note that in 1981, when the divergence between M1 and nominal GNP first emerged, the definition of M1 was changed by the Federal Reserve to reflect regulatory changes that allowed depository institutions to offer interest bearing checking (NOW) accounts. The Fed assumed that the NOW accounts would be treated the same way as demand deposits and, thus, included them in their measure of M1. However, as the defenders of monetarism point out, individuals who hold NOW accounts treat them much more like a savings account than a transactions account. They note, for example that whereas demand deposits have an annual turnover rate of 434, reflecting their role as a transactions account, the turnover rate for NOW accounts is only 15 times per year, which is much closer to that of a savings account (which has never been included in M1). This distinction, they argue, is of critical importance because much of the growth in M1 over this decade has come from growth in NOW accounts. As John Paulus, Chief Economist for Morgan Stanley, has recently reported, from 1981 to the present, NOWs and super NOWs have accounted for 73 percent of the reported growth in M1.

When Paulus adjusted for this definitional change by redefining M1 simply as cash plus demand deposits, which is how it was defined until 1981, he discovered that the observed change in velocity largely disappeared. This implies, of course, that there was no shift in demand, only an "error" in definition which has misled policymakers as well as the proponents and opponents of monetarism. According to Paulus, from mid-1982 to mid-1983, for example, the growth in "new" M1, upon which most monetarist predictions were based, accelerated to 12 percent, while "old" M1, which excludes NOWs, increased by only 7 percent. Thus, monetary policy was not nearly as stimulative as most people believed at the time. This divergence between the two measures has continued through the present, and, thus, explains some of the observed differences between monetary growth and nominal GNP over the period.

But does this explain all of it? Even after the definitional adjustments that restore M1 to its old self, there still appear to be discrepancies between changes in money and nominal income. For example, recent trends in old M1 hardly seem to suggest a tight money supply, although monetary policy as defined by old M1 was not nearly as loose as trends in new M1 would suggest. Yet, since mid-1984, the economy, prices, interest rates, and other measures do seem to be reacting to something more restrictive than the redefinition suggests.

This suggests that the truth lies somewhere in between the two contending forces – the "redefined" monetarists and their opponents. Redefining M1 does take away some of the mystery, but not all of it, while the possibility that the demand for money did shift during the early 1980s may explain the rest.

Does this imply that monetarist views have no value? Not by a long shot, but it does suggest caution in relying on mechanical rules that may occasionally be subject to exceptions whose existence may be difficult to predict or realize. History does suggest that the demand for money is generally stable, but shifts in demand do occur and such shifts may be difficult to predict or measure. Beginning early in this decade, monumental changes occurred in the economic environment. Inflation was brought under control, financial institutions were deregulated, new financial assets were developed and the tax code was substantially changed. All of these changes must have had some impact on the demand for money, and some increase in society's willingness to hold money probably did occur.

But at some point, this increased demand will be satisfied and, if price stability is maintained, the previous pattern between money, however defined, and nominal income will reemerge. This, then, suggests a note of caution to the opponents of monetarism who are now urging an even looser monetary policy than is already implied by the double-digit rates of growth in new M1. Once the "stock adjustment process" is complete and the patterns of the past reemerge, excessive growth in the money supply will begin to have an adverse effect on inflation. When this adjustment process will end is anybody's guess, but at some point it will end. The demand for transactions balances is not insatiable and some measure of caution is imperative if we are to avoid the mistakes of the past.

REGIONAL SURVEY

by

Rajni Bonnie Ohri

Now almost four years old, America's recovery from the 1982 economic downturn continues, albeit at a more moderate pace. The slide in the value of the dollar, lower oil prices and interest rates, and improvements in economic activity of our trading partners are the main factors that should help buoy growth in the national as well as regional economies. Energy-intensive, credit-sensitive and exporting industries and regions are the obvious beneficiaries of current conditions. Other regions, however, will not fare as well, and the uneven performances of major industrial sectors will be reflected in regional economic activity. Nonetheless, the overall economic environment remains relatively bright for the remainder of this year and next.

As is too often the case, the media focus has been on the bad news. In newspapers across America, headlines give us daily reports concerning the problems in agriculture, oil and related sectors, the slowdown in the computer industry, and the fluctuating performance of America's traditional manufacturing industries. This article examines regional economic performance during the past year, focusing on factors which account for the disparity in economic conditions around the nation. The analysis reveals that those regions, in particular New England and the Pacific, which have benefited the most from the strength of the expansion, share similar industrial characteristics such as a diversified industrial base and a favorable business climate. Regions which now lag behind (West North Central, West South Central and East North Central), are relatively more dependent on a few specific industries which have suffered over the past several years.

Behind these more obvious patterns are several significant trends that are certain to affect the U.S. manufacturing climate. Many states realize that they can no longer rely solely on their existing manufacturing base and are developing new information-age strategies to remain competitive. Around the country, high technology firms are sprouting up besides farms and factories. California's Silicon Valley still leads in high-tech activity, but Florida, Massachusetts, Texas and North Carolina are close on its heels.

Recognizing that the U.S. economy is now intimately integrated with the world economy, many states have regularly led missions on a worldwide search for industries to relocate within their borders. In 1985, there were 325 new foreign manufacturing investments in the U.S., with the largest number settling in New York and California. Other states which have experienced a significant increase in foreign manufacturing investment are Washington, Georgia, Oregon, Alabama and North Carolina. In addition, more states are becoming aware that exporting is an integral part of their economic development. Indeed, over half of the states, including Oklahoma, Texas, Illinois and Nevada, now have offices in Japan and Europe to facilitate trade.

Overview

America's demographic profile reflects a continuing urge to follow the sun. Between 1980 and 1984, the fastest growing regions in terms of population growth were still the South and the West. California, Florida, Texas, and Arizona are expected to have the largest increases in population growth between 1985 and the end of the century. Significant gains in population are also expected in New England and the Midwest, with Massachusetts and Connecticut growing rapidly. Relatively small population declines are projected for the District of Columbia, West Virginia, South Dakota, Nebraska and Iowa.

As shown in Table 1, per capita personal income for the nation as a whole posted a healthy 5.3 percent nominal increase in 1985 compared to 1984. The New England, Middle Atlantic and West North Central states enjoyed above average income growth, while the slowest growing regions were the West South Central, East South Central and Mountain states. State nominal personal income per capita in 1985 ranged from $17,756 in Alaska to $9,035 in Mississippi, compared to a national average of $13,451. According to the Department of Commerce, the states expected to enjoy the largest percentage increases in personal income between now and the end of the century are Arizona, Nevada and Utah. Pennsylvania, Illinois and New York are anticipated to have the smallest increases over the same period.

TABLE 1

PER CAPITA PERSONAL INCOME BY REGION

($ Thousands)

	1984	1985	Percent Change 1984-85
U.S. Total	$12,772	$13,451	5.3%
New England	14,429	15,387	6.6
Middle Atlantic	13,896	14,740	6.1
South Atlantic	12,254	12,897	5.2
East North Central	12,698	13,337	5.0
West North Central	12,532	13,296	6.1
East South Central	9,952	10,407	4.6
West South Central	11,886	12,401	4.3
Mountain	11,791	12,328	4.5
Pacific	14,030	14,751	5.1

Source: U.S. Department of Commerce, *Survey of Current Business*, April 1986.

In the year to March 1986, national retail sales increased by 3.5 percent. Regional performance ranged from a 11.1 percent increase in retail sales activity in the New England states to a decline of 2.2 percent in the West South Central states (see Table 2). The data agrees with results from the Chamber's Early Outlook Sales Survey, a nationwide compilation of retailer's expectations.

TABLE 2

RETAIL SALES BY GEOGRAPHIC AREA

Region	Percent Change March 1986 from March 1985
U.S. Total	3.5
New England	11.1
Middle Atlantic	9.2
South Atlantic	4.0
East North Central	2.6
West North Central	1.8
East South Central	2.0
West South Central	-2.2
Mountain	2.4
Pacific	1.1

Source: U.S. Department of Commerce, *Current Business Reports*, March 1986 (issued May 1986).

In April of this year, the nation's civilian unemployment rate stood at 7.1 percent, down from 7.3 percent in April 1985. As Table 3 shows, most of the regions shared in the improved employment situation. New England's jobless rate is 4.3 percent and falling fast. However, the South Central region's unemployment rate is over 9 percent. Reflecting the problems in the oil and mining industries, Louisiana, Mississippi, West Virginia and Wyoming have the highest unemployment rates in the nation. New England's diversified economy is exemplified by the fact that New Hampshire, Connecticut, and Massachusetts have enjoyed the lowest unemployment rates in the nation during the past two years. By industry, almost every region reported job gains in trade, services and finance, insurance and real estate, and over one-third of the nation's nine census regions experienced increases in manufacturing employment. The National Planning Association ranked Los Angeles first in job-creating ability and anticipates that a total of one million new jobs will be created there by the year 2000. Boston, Anaheim, San Jose and Phoenix are all projected to experience employment increases ranging between half a million and one million jobs during the same period.

TABLE 3

CIVILIAN LABOR FORCE UNEMPLOYMENT RATE

(Percent)

Region	April '85	April '86p	Annual Rate 1985
U.S. Average	7.3	7.1	7.3
New England	5.0	4.3	4.7
Middle Atlantic	6.6	5.9	6.4
South Atlantic	7.1	6.2	7.0
East North Central	8.9	7.8	8.6
West North Central	6.1	5.8	6.0
East South Central	9.0	9.4	9.2
West South Central	8.5	9.4	8.6
Mountain	7.5	7.9[a]	7.2
Pacific	8.3	8.3	8.2

(p) Preliminary data

(a) Note: 1986 unemployment rate for Colorado not available.

Source: U.S. Department of Labor, Bureau of Labor Statistics.

New England

Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont

New England's economy should continue to exhibit robust growth this year and next. The region is banking on new businesses, venture capital and foreign investment to tide it over the slump in the computer and high-technology industries. Small firms are expected to create most of the 110,000 new jobs forecast for this year in the region; nearly half of those jobs will be in Massachusetts. Maine and Rhode Island, somewhat slower to adjust their industrial pace, will lag behind. A recent report by *INC. Magazine* cited Connecticut and Massachusetts among the top five states with the best business environment, particularly for small businesses.

Reflecting the region's strength, New England enjoys both the nation's highest per capita income and lowest unemployment rate (4.3 percent). Indeed, regional economic growth appears to be outpacing the rapid expansion of the labor force. Correspondingly, manufacturing wage levels in the region have risen by 10 percent over the last two years, compared to a 7.5 percent increase for the nation as a whole. The rise in total employment has improved consumers' real disposable income, creating greater demand for services, durable goods, and houses.

Regional employment strength is concentrated in the defense and service sectors and has offset some of the weakness in manufacturing employment. Increased defense spending is expected to keep Massachusetts unemployment down to 3.8 percent of the labor force. Last year, Massachusetts received $7.7 billion in defense contracts, making it the fourth largest holder of defense contracts in the country, accounting for some 240,000 jobs. Companies such as Raytheon and General Electric will also receive research dollars from the Star Wars project, increasing employment substantially in the state. GTE is expected to add 1,000 employees to its rolls over the next two years. Many of these jobs will open at its Needham, Massachusetts plant as it goes to work on a $4.3 billion communications contract for the Army. However, not all new jobs in Massachusetts will stem from defense-related industries. About 12,000 new jobs have been created in the skilled services of finance, law, advertising and insurance.

Connecticut's economy is also benefiting from increased defense contracts. Although Rhode Island's heavy manufacturing base has been hard hit by import competition, the state has been successful in attracting high-tech businesses. A boom in the service industries and overall business expansion has kept Maine's economy solid and growing. Manufacturing sector employment has not fared as well. In particular, the region's shoe industry has suffered from increased import competition. In Maine, eight shoe factories have closed in the past 18 months, with a loss of 7,600 jobs. In New Hampshire, where shoemakers employed almost 11,000 workers a decade ago, fewer than 7,000 people are at work this year.

With over a quarter of its manufacturing output in electronics, computers, instruments, nonelectrical machinery and machine tools, the region has an impressive base of products. But, most of these industries are expected to exhibit slow growth this year and next. Indeed, producers of high-tech electronics and telecommunications devices should experience growth rates of only 7 percent in 1986, half the rate achieved in recent years. However, business research services are growing rapidly, reflecting the strength of manufacturer's demand for research and development and data processing services. The region's export-oriented industries are recovering from the effect of the strong dollar, and capital goods producers are experiencing an increase in foreign orders. Rudolph Beaver Inc., a maker of surgical blades in Waltham, Massachusetts, finds that export orders are 20 percent higher now than they were a year ago.

The construction boom and the mix of industry within the states helps to explain the robust economic growth of New England. Construction of new homes is showing a tremendous increase so far this year, compared to the same period in 1985. Nevertheless, certain states such as Connecticut and Massachusetts, continue to suffer from scarce housing and spiraling housing costs. One cloud on the horizon is that growth may be constrained by labor shortages – a problem many other regions wish they were facing.

Middle Atlantic

Delaware, New Jersey, New York, Pennsylvania

Economic activity in the Middle Atlantic region increased at a slightly higher pace than national economic activity during the first quarter of 1986. The housing, retailing and banking sectors all showed significant strength, while manufacturing industries continued to lag behind. The region – with the exception of Delaware, which has maintained steady growth over the years – is in the process of reversing years of decline. Progress has been made by keying into high-growth industries and by diversifying existing industries. This diversification has led to a stabilization in population, in contrast to the declines registered during the last ten years, and a concomitant increase in the regional labor force.

Residential construction grew by 21 percent in the region last year, fueling increases in construction employment and related industries such as stone, and clay, brick and glass. Similar to the New England region, strong pent-up demand has yet to be matched by a sufficient increase in new housing, leading to shortages and rising prices for housing throughout the region. Although the region's manufacturing sector continues its lackluster performance, the lower value of the dollar is already helping some local firms recover lost ground. Hale Fire Pump Company in Conshohocken, Pennsylvania has doubled its sales agents overseas due to an increase in foreign orders. MC Products Inc. in Hauppauge, New York, a manufacturer of water-level gauges for fire trucks, now prints its plates in several foreign languages due to a rise in European orders.

Industry analysts expect that 14,000 new jobs will be created this year in the high-tech and service industries of the New York/New Jersey area. In addition, New York's vast printing and publishing industry is expected to grow by 5 percent this year. Boosting New Jersey's economy is the fastest growing airport in the country in Newark, which has created thousands of new jobs and has already encouraged over 400 companies to relocate to the area. In addition, Merrill Lynch has created over 1,400 jobs in Princeton. Tourism, in the northeastern section of the region, is expected to increase this year as vacationers avoid foreign travel in the wake of terrorism and nuclear fallout. Delaware and New Jersey's tourist industries are thriving.

The spread of high-tech industries in eastern Pennsylvania and southern New York has helped to offset the weakness of the traditional smokestack industries. In Pennsylvania, 1985 employment losses were concentrated in manufacturing industries, including primary metals, textiles and apparel, nonelectrical machinery and transportation equipment. In January of this year, Mack Trucks, Inc. closed its assembly plant in Allentown and relocated to South Carolina, laying off 1,800 workers. In contrast, high-technology firms and electronics companies created over 2,300 jobs in 1985. An ambitious $2 billion state government program, called Strategy 21, has been created to encourage development of scientific and advanced technology firms within the state, particularly in the area of robotics. In 1985 alone, Pennsylvania saw the creation of 20,100 jobs in four areas: services and finance, retail and wholesale trade, and construction.

Pittsburgh, still clinging to the title of America's "Most Liveable City," stands as an example of the successful transition from a smokestack economy to an information economy. The steady growth of high-tech companies as well as the medical and banking industries, has helped the city weather a decline in steel manufacturing. Foreign and domestic companies are attracted to the city because of its stable growth, availability of local resources, and sufficient capital to help finance projects.

South Atlantic

District of Columbia, Florida, Georgia, Maryland, North Carolina, South Carolina, Virginia, West Virginia

The South Atlantic region should fare well this year. The region's unemployment rate stands at 6.2 percent and can be expected to fall further if current economic trends continue. The mix of service-related industries in the region has provided some insulation from the employment declines that plague its manufacturing-dominated economy.

Florida and Georgia will again be the national leaders in employment, retail sales and personal income growth. Both states are benefiting from increased activity in defense-related manufacturing. Moreover, their tourism and recreational facilities are expected to exhibit robust growth this year and next. However, some manufacturing industries, including electronics machinery, food, paper and chemicals bore the brunt of import competition, declining foreign demand, and industry-specific problems. In 1985, Georgia saw remarkable employment growth, with the creation of 160,000 new jobs. The computer, telecommunications and software companies that have sprung up in Atlanta's "technology crescent" have also generated a substantial amount of employment. Thanks to its high-tech factories, Gwinnett County is the nation's fastest growing county. The city of Braselton soon will be turning out color televisions and cellular mobile telephones at the largest U.S. plant of Japanese electronics giant Mitsubishi.

Other states in the region are also outperforming the regional average. In the electronics, electrical machinery and other high-tech industries of North Carolina and Georgia, 50 foreign firms expanded their operations. Already recognized as the high-tech capital of the southeast, the Research Triangle of North Carolina produced a fifth straight year of record-breaking construction activity. The Raleigh-Durham area has witnessed the creation of 1,000 new jobs this year as a result of the location of the American Airlines hub. By 1987, Mack Trucks, Inc. plans to open a new plant in South Carolina which will employ over 1,000 workers. Companies in Virginia are snaring defense contracts, which along with tourism and services, are keeping the state's economy strong. Biotechnology, computer technology and service industries continue to boost Maryland's employment.

The economic picture for the other states in the region is mixed. The middle south is heavily dominated by older, basic industries such as textiles, apparel, tobacco and furniture. Heavy capital spending for plant modernization in each of these industries last year not only spurred the construction sector but helped to make them more internationally competitive. In the Carolinas, which account for 60 percent of the nation's textile employment, unemployment is expected to climb as more jobs are lost this year. Last year, Manchester, Georgia lost two plants and 600 jobs. In order to stay in business, many textile firms have begun producing industrial fabrics and household goods, "geotextiles" or "geomembranes"–durable sheets of fiber and plastic increasingly used in drainage, erosion control, and construction. Now in the third decade of decline, the region's agricultural employment will fall further as tobacco farmers brace for a loss of price supports and markets; over 10 percent of the tobacco farmers are expected to go out of business in 1986.

West Virginia has the highest unemployment rate in the region (10.8 percent), with no relief in sight. The state is spending much of this year recovering from last November's flooding which wiped out an estimated one-fourth of its small businesses. Charleston, West Virginia stands to lose 2,000 jobs this year, due to layoffs at Union Carbide and the closing of two major plants–Volkswagon and FMC Corporation, a chemical company. In addition, coal mine closings have accentuated existing problems.

East North Central

Illinois, Indiana, Michigan, Ohio, Wisconsin

America's "Rust Belt" is making a comeback. While still tied to agriculture and smokestack industries, government officials and private industry leaders in the East North Central region are creating an environment conducive to new business growth. Businesses there are battling back by adapting high technology such as robotics, computer-aided engineering and automation, to the region's auto, machine tool, metal-fabricating and part-assembly industries. Indeed, the number of machines driven by computers has soared by 600 percent at Ford Motor's transmission plant in Livonia, Michigan.

Consumer-related businesses such as autos and appliances are doing well, while heavy industry and equipment manufacturers continue to face troubled times. Transportation and other machinery account for over a third of the manufacturing strength of the East North Central states, and industry output is expected to increase modestly this year. Automakers are planning to maintain sales incentives throughout the year despite the onslaught from imports. Moreover, several states are wooing foreign automakers to set up production facilities in their area. Currently, there are seven Japanese companies planning to produce autos or trucks in the U.S. Honda Motor Company's Marysville, Ohio complex now assembles Accord cars for about the same cost as in Japan.

Mazda Motor Company has completed its auto assembly plant in Flat Rock, Michigan, creating 3,500 new jobs. A Mitsubishi Motors Corporation auto manufacturing plant will also bring thousands of new jobs to Normal, Illinois next year. The expansion of these auto plants should send welcome ripples throughout the region as related industries, including auto parts, steel, chemicals and fabricated metals, benefit from the increase in auto production.

Prospects for steel manufacturing in the region have increased as mini-mills boost output and productivity levels. A rapid growth in steel service centers in recent years has secured Chicago's position as the nation's steel distribution center. The newly developed Great Lakes Industrial Center in Gary, Indiana houses 15 steel-related companies and provides employment for over 800 workers. Indiana's mills are a crucial link in the region's industrial economy, supplying steel sheets to the automotive and appliance industries and bars and plates to heavy equipment makers.

By far the strongest recovery area is Michigan, which is aggressively pursuing high-tech, streamlining its auto industry and encouraging business development in the area of robotics. Michigan now produces a third of the nation's robots. This year will see increased employment in construction and related industries due to several new projects: a paper mill renovation in Munising, a waferboard plant near Sagola, and an Olympic training facility in Marquette. The economic benefits of the reopened White Pine copper mine and the new Quinnesec paper mill have also spread to surrounding towns.

In addition, the lower value of the dollar is slowly benefiting manufacturers throughout the region. Caterpillar Tractor of Peoria, Illinois—where 15,000 jobs hinge on the company's $1.9 billion worth of export sales—reports that shipments of diesel engines to Europe are running 15 percent ahead of 1985. L.R. Nelson Corporation in Peoria, a lawn sprinkling systems manufacturer, is adapting its products to foreign requirements as export orders pick up. Nicolet Instruments Corp., a Wisconsin-based exporter of analytical and computer graphics equipment, has increased employment to meet the demand created by an increase in European orders. And Cincinnati Milacron Inc. expects machine tool orders to pick up by the end of this year.

East South Central

Alabama, Kentucky, Mississippi, Tennessee

At 9.4 percent of the labor force, the East South Central region's unemployment rate is one of the highest in the nation. The continuing problems in agriculture and in the oil-related sectors, as well as the region's dependence on heavy industry are responsible for the economic weakness experienced by Alabama, Kentucky and Mississippi. While defense-related manufacturing should fuel the local economies, the recent space shuttle tragedy will affect areas dependent on the aerospace industry. The apparel and textile industries, especially in Alabama and Mississippi, have experienced a dismal year because of keen competition from imports. Nevertheless, growth should pick up this year as the decline in the value of the dollar and interest rates, and an improving international economy help the region's manufacturers increase exports, particularly sales of chemicals.

Spring Hill, Tennessee is currently benefiting from the General Motors $3.5 billion Saturn plant and the 20,000 jobs the factory complex promises to generate. In addition, the decision of American Airlines to establish a regional hub in Nashville will result in the creation of over 1,000 jobs. The expansion of Nissan USA's $750 million truck assembly plant in Smyrna will also increase employment opportunities in the area. More than half a billion dollars in new capital projects have been planned in the state, which will result in the creation of an estimated 14,000 jobs. Georgetown, Kentucky also received an economic boost in December when it was chosen as the site of the Toyota Motor Corporation car assembly plant which will create over 3,000 new jobs.

Last year's slowdown in such manufacturing industries as lumber, textiles and apparel has affected the economies of Mississippi and Alabama. Although the downturn was rather severe, the decline in the real value of the dollar, low interest rates and anticipated brisk export sales make prospects look brighter. Tire plants and other auto parts suppliers have been prospering due to strong auto sales. Uniroyal Tire Company announced a $10 million expansion of its Opelika plant, which is expected to add 300 jobs to Lee County, Alabama this year. In an effort to generate more international trade, Alabama is opening business development offices in foreign countries. And, 100 foreign-owned companies from 18 countries have located in the state, bringing total foreign investment to over $2 billion and generating about 15,000 new jobs.

Increased construction activity this year should stimulate Mississippi's lumber industry which is expected to see modest growth. The region's agricultural sector has been beset by reductions in foreign demand, low commodity prices and heavy indebtedness among farmers. The oil and gas industries also face deteriorating market conditions, depressed prices and abundant capacity. Drilling activity has been cut back dramatically as companies concentrate on servicing old contracts or holding leases. During 1985, the average number of rigs in operation fell to 29, down sharply from an average count of 80 rigs in 1981.

West South Central

Arkansas, Louisiana, Oklahoma, Texas

If any part of the nation is looking at a shifting future, it is the West South Central region. Many industries in these four states are in the throes of a fundamental structural adjustment process, similar to that being experienced by the Midwest, that seriously constrains short-term growth prospects. Growth will be slow this year as businesses that prospered with the oil boom continue to adjust to the low demand for petroleum and petroleum-related products. With total employment rising slower than population growth, the unemployment rate has increased in all four states. Louisiana's unemployment rate stands at over 13 percent, the highest in the nation.

According to estimates by the Southern Methodist University, every one dollar fall in the price of crude oil costs Texas 25,000 jobs, $3 billion in purchasing power, and $100 million a year in state and local tax revenue. Twenty-two percent of what the state produces is tied to energy and petrochemicals, making Texas five times more dependent on the oil and gas industry than the country as a whole. The hardest hit industries are oil extraction and oil-field equipment manufacturing where employment has fallen by 60 percent since 1981. In addition, U.S. oil and natural gas drilling activity is the lowest since 1943, with Texas leading the drilling downturn and Oklahoma and Louisiana following close behind. The strongest ripple from the oil price plunge has been seen at the large oil companies in the form of personnel cutbacks: Atlantic Richfield recently cut 2,100 workers in Dallas; Tenneco laid off 500 workers in Houston; Baker International dropped 800 workers from its Houston companies; MCO Resources cut one-third if its work force; and Texas Oil and Gas reduced its roster by 15 percent. Approximately 76,000 jobs have been lost over the past three months.

Although the energy sector will remain a drag on the Texas economy, growth in the services and high-tech sectors is likely to partially offset weakness in this sector. Most of the region's recent job growth has occurred in the "Silicon Gulch" (the Dallas-Fort Worth corridor), one of the nation's hot spots for high-tech industrial development. In addition, the government remains the aerospace industry's largest customer, accounting for over 60 percent of all new orders. As in other parts of the nation, the region's strongest performers are the defense and electronics industries. Houston remains the nation's leading supplier of agricultural chemicals, fertilizers and fuels. San Antonio has recently launched several programs to establish itself as a premier location for biotechnology research and commercial applications.

The declining energy sector in Louisiana and Oklahoma has also led to job losses in the mining, construction, and transportation industries. However, as in other states, auto production continues at a healthy pace, partially offsetting the weakness in energy and agriculture. Nevertheless, falling oil prices will enable the energy-using industries, such as electrical and transportation equipment, paper and chemicals, to stabilize and grow moderately this year. Some large shipbuilding and aerospace firms are benefiting from Navy contracts to build troop and fleet oiler ships and other military hardware, thus increasing employment in the area.

In Arkansas, government officials have launched a $3 million promotion campaign to attract business development to the state, primarily in the area of high tech. In general, the South Central states have been struggling to keep pace with the national economy, and this year will be no different.

West North Central

Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, South Dakota

Despite its increasingly diverse industrial base, the economy of the "deflation belt" continues to face troubled times. Growing stocks of farm commodities, mounting debts, sluggish farm export demand, and falling farm asset values are sapping the economic vitality of American agriculture. Land values have been falling since 1981 and, in Iowa and Minnesota, are now 58 percent and 52 percent respectively, below the 1981 peak. Exports, an important revenue source, remain sluggish, having fallen by 18 percent in value and 12 percent in volume in fiscal 1985 over fiscal 1984. Prices of commodities produced in this region, including wheat, corn, milk, cattle, hogs and poultry, have declined drastically, some by over 30 percent. In Missouri and Kansas, where one in eight farmers holds virtually unrepayable debts, about 6 percent will leave farming this year. Negligible population growth and economic uncertainties in the agricultural and energy sectors do not bode well for regional employment and retail sales activity.

Sales by farm capital goods manufacturers are off sharply and the U.S. farm equipment industry is currently operating at about 40 percent of capacity. John Deere & Company, a farm equipment manufacturer, has reduced the workforce in its Iowa dealerships by 50 percent. Caterpillar Tractor has also laid off workers in Illinois and Iowa. Companies specializing in machinery for oil, construction, and farming equipment industries are in for a rough time this year and next. There will also be a continuing decline in the region's manufacturing industries, particularly in steel, apparel and shoes.

Those states whose economies do not depend solely on agriculture, farm machinery, meatpacking or heavy industry are performing significantly better than the regional average. According to a study by Grant Thornton, American manufacturers ranked South Dakota as the state with the best business climate for manufacturing firms in the nation; North Dakota was ranked fifth. South Dakota led the region in job growth thanks to the vigor of its banking and high tech industries. Military spending will boost the state's economy substantially, generating employment in the B-1 bomber base under construction near Rapid City and at the new Air Force training complex near Belle Fourche. Construction, and auto and aircraft production in Kansas and Missouri provided the major impetus to those states' economies. In general, the prospects for the aerospace/defense/commercial aviation sector are the brightest among basic exporting activities. Indeed, Boeing Military Aircraft Company is creating substantial employment opportunities in the region.

Some metropolitan areas within the region are also outperforming the regional average. Council Bluffs, Iowa has embarked upon a program to finance business growth in electronics, food processing, telecommunications and warehouse distribution. So far, seven firms have relocated there, creating 285 jobs through $9.1 million in investment. Bordeaux, Inc., an Iowa company that contracts for its labor, is one of a number of cottage-industry businesses that have sprouted in the Farm Belt. These businesses, which hire people to work at home, are providing a glimmer of hope in an otherwise depressed agricultural economy. Thanks to successful business ventures, new commercial megaprojects are under construction in St. Louis, Missouri. The Twin Cities have attracted several high-technology firms and have become a big center for health care providers, telephone companies, and financial institutions. Omaha, Nebraska has become the nation's largest telemarketing industry, including WATS Marketing of America.

Major oil companies are reevaluating exploration plans in the West North Central states. Some of them are reducing their activities by about two-thirds and decreasing employment by almost as much. Minnesota's problems are compounded by the mining depression in the Iron Range, where 15,000 jobs have been lost since 1980—a third of them in the past year. Although the outlook for the region is for slower growth, especially in the farmbelt, the general improvement in the economic climate should help the region readjust to a changed economic environment.

Mountain

Arizona, Colorado, Idaho, Montana, Nevada, New Mexico, Utah, Wyoming

The Mountain region continues to be marked by divergent economic trends. Arizona, Colorado, Nevada, New Mexico, and Utah are experiencing rapid growth in the service industries, high technology and other state-of-the-art manufacturing. Although hard-hit by the demise of the southwestern energy boom, the diversified economies of these states have more than offset the losses in the energy sector. In contrast, the more northern states of the region—Idaho, Montana, and Wyoming—remain heavily dependent on mining, forest products, and agriculture, and have been unable to shake off the effect of declining prices for these industries.

Arizona and Colorado, in particular, are deriving over one-third of their income from electronic, electrical and computer-related products, telecommunications and instrumentation. IBM Corporation, Tucson's second largest employer with about 5,500 employees, is attracting development to the city. Moreover, AiResearch, a division of Garret Corporation, is establishing its electronics operations in Tucson and is expected to create hundreds of jobs. Over 1,300 high-tech companies have relocated to Denver in recent years. However, high-technology activity (centered along the Fort Collins-Colorado Springs corridor), slowed significantly this year. Layoffs and plant closings became commonplace as the demand for computers, component parts and peripheral equipment softened.

Defense and space research firms in New Mexico, Wyoming and Arizona will be busy with new contracts this year. Consolidated Space Operations will start controlling military satellites in late 1986. The first 10 MX missiles will go into silos at Warren Air Force Base in Cheyenne, Wyoming. Research and testing of the Strategic Defense Initiative—Star Wars—promise full employment at Los Alamos National Laboratory and other scientific centers. Both Sperry and General Electric have aircraft related manufacturing operations in New Mexico, employing over 3,000 people. Hughes Aircraft Company added over 2,000 workers last year to its Tucson plant. On another front, Utah's Bionic Valley near Salt Lake City is expected to continue as a focus of research on artificial hearts.

The region's metals mining industry will continue to be battered by low prices and foreign competition. The industry also faces substantial downsizing and substitution of new and lighter materials in construction and in the production of autos and heavy equipment. In Utah, Montana and New Mexico, mining activity slowed sharply last year, the result of continued weakness in copper and uranium mining. Beker Industries Corporation plans to close its phosphate mining operations in Idaho due to weak fertilizer demand. One bright spot in the otherwise depressed mining industry is the scheduled development of a platinum and palladium mine in southern Montana which is anticipated to hire about 200 workers. Prospects for the copper industry may also start to pick up. The Japanese are scouring the world for copper concentrates for which there is a relatively high industrial demand.

Last year, the Sumitomo group took a 15 percent stake in America's biggest mine, Phelps Dodge's Morceni mine in Arizona.

Farmers and ranchers in the region have suffered not only from low agricultural prices and falling land values, but also from an extended drought and crop losses of $188 million in 1985. Of the roughly 5,500 cattle ranchers in Wyoming about a quarter are facing foreclosure. A further source of distress is the federal program to reduce dairy surpluses by slaughtering nearly 1.6 million cows, thus depressing beef prices even further. Although the outlook for the region is for slower growth, it should be more managable and more likely to guarentee healthy economies in the future.

Pacific

Alaska, California, Hawaii, Oregon, Washington

The economies of the Pacific region are banking on continued growth in the electronics, aerospace and defense industries. As in the Mountain states, the Pacific also depends on agriculture, energy, forestry and mining. The results of this diversified industrial makeup are instantly apparent: The Pacific states have the highest job creation rate in the nation and the second highest rate of population growth. The National Planning Association ranked Los Angeles first in job expansion in the nation, anticipating that by the year 2000, the city will have created a total of one million new jobs.

The region's strongest growth industries continue to be aerospace and defense. The non-defense electronics industry, which exhibited strong growth in 1984, stagnated in 1985, primarily due to a slump in semiconductor activity. Weakness in this industry is due to decelerating sales of microcomputers, intensified Japanese competition, as well as a severe inventory imbalance caused by stockpiling and overproduction. This weakness has been reflected in widespread layoffs, reduced work weeks and plant shutdowns throughout the region. Indeed, Hewlett Packard recently offered 1,800 employees early retirement plans due to the slowdown in the computer industry. In California's Silicon Valley over five percent of the jobs in electronics manufacturing were lost in 1985. After phenomenal growth rates of over 20 percent per year, it is hardly surprising to see the pace of the electronics industry slow down.

In Oregon and Washington, major efforts to lure new business into the state, especially high-tech oriented ones, have been successful. Several Japanese electronic firms have announced their decision to locate in the "Silicon Forest" on the outskirts of Portland. Washington's economy has been bolstered by defense and aircraft orders pouring in for the 83,000 workers of Boeing, the state's largest employer. RCA-Sharp recently opened a plant at Camas, creating substantial employment in the area. The Port of Tacoma has emerged as a major intermodal shipping center, revitalizing the U.S. maritime industry and attracting such shipping firms as Sea-land and Maersk.

Foreign competition, high interest rates, chronic overcapacity and moves by some timber giants, such as Georgia Pacific, into the lower-cost South, have left the timber indusry in disarray. As a consequence, mills have shut down and timberland values have plummeted. On June 16, a strike against the Weyerhaeuser Company by 8,000 woodworkers shut down sawmills in Oregon and Washington. Some 48,000 lumbering jobs and millions of dollars have been lost in Idaho, Oregon and Washington since 1980.

However, recent signs are encouraging for the timber industry as price indices for various forest products are rising and demand for new housing remains healthy. Indeed, according to the American Paper Institute, exports of wood pulp were up 50 percent since January of this year from the same period in 1985 due to the fall in the value of the dollar. Louisiana Pacific recently agreed to lease a waferboard mill near Klamath Falls, Oregon, providing substantial employment in the area.

As in other regions, farmers are grappling with low product prices, soft foreign demand, declining land values and heavy debt burdens. Particularly hard hit by these problems have been California's specialty crops, notably grapes. The tourism industry should experience another year of strong growth in 1986, especially in Alaska, California and Hawaii. Washington hopes to get spillover business from the four million people expected to visit the Vancouver World's Fair in British Columbia. Growth should remain strong in the region, as the reduced value of the dollar, together with industry shakeouts, cause the agriculture, forest products and electronics industries to stabilize next year.

GRAMM-RUDMAN-HOLLINGS AND THE FEDERAL BUDGET: AN ASSESSMENT AND OUTLOOK

by

*Cesar V. Conda**

With all the euphoria and hoopla surrounding the Senate Finance Committee's historic tax reform bill, Congress and the public seem to have forgotten about the

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federal budget, which is now in the process of being put together for the next fiscal year. To date, the House-Senate budget conference has proceeded with little fanfare. The budget process deadlines established by the Gramm-Rudman-Hollings Act (G-R-H) have come and gone without much concern being expressed about them.

The budget's "disappearance" may also be due to the fact that G-R-H is perceived to have worked. Interest rates have dropped, federal spending growth has slowed and the deficit is projected to shrink. As the situation now stands, the budget question will not be resolved until late this summer, when the end of the current fiscal year will precipitate a funding crisis.

But several developments along the way will propel the federal budget back to the top of Congress' policy agenda. The Supreme Court is expected to decide in July on the constitutionality of the G-R-H's automatic sequestering mechanism. On August 1, the Senate is scheduled to begin floor consideration on the bill to raise the public debt ceiling. On August 15, the CBO (Congressional Budget Office) and OMB (Office of Management and Budget) will make their joint estimate of the fiscal 1987 deficit to determine whether or not a sequester will be triggered.

As has so often been the case, the fundamental economic and political dispute over the issue of tax increases to reduce the deficit lies behind the budget impasse. The President remains vehemently opposed to raising taxes, while Congress claims that a tax hike is necessary to meet the G-R-H deficit ceilings. Meanwhile, the threat of an across-the-board sequester which would slash both defense and several domestic programs may force an unwise compromise on taxes.

This article seeks to assess the impact of the Gramm-Rudman-Hollings Act, and to examine the possible outcomes of this year's budget battle.

The Impact Of The Gramm-Rudman-Hollings Act

The emergence of the Gramm-Rudman-Hollings Act stems directly from Congress's failure to control the growth of federal spending. In recent years, it had become clear that the federal budget process did not work. Federal expenditures rose 17.8 percent, in inflation-adjusted terms, during the first Reagan term and 7.4 percent in FY 1985. Recognizing that new rules were required, G-R-H was designed to provide a much needed framework to reduce deficit spending over the next five years. The Act mandated fixed ceilings on the annual federal budget deficit, reformed the budget process to enhance the likelihood that Congress will abide by the annual deficit ceilings, and created an action-forcing mechanism, commonly referred to as "sequestration," which would reduce outlays by formula should Congress fail to reach the mandated deficit ceilings on its own. In the event of a sequester, nonexempt federal spending programs would be reduced by a uniform percentage with the total burden of the reductions being borne equally between defense and certain domestic programs.

The track record to date shows that G-R-H has had both positive and negative effects. On the positive side, G-R-H has resulted in real reductions in federal spending. On March 1, the sequestering mechanism slashed $11.7 billion from the FY 1986 budget. In an effort to ease the task of complying with next year's deficit ceiling, Congress resurrected and approved the reconciliation bill left over from 1985. This action saved another $11.5 billion. Overall, the Act has discouraged members of Congress from proposing new and costly spending programs.

The latest U.S. Treasury budget figures show that spending growth has slowed considerably. Total outlays are 4.9 percent higher through the first half of 1986 compared to the same period last year. For the full fiscal year, the Treasury Department estimates that outlays will rise by only 3.7 percent. This is in stark contrast to the 11.1 percent spending explosion in 1985.

A closer look at the components of federal spending in fiscal year 1986 shows that several budget accounts are actually lower through the first half of this year compared to the same period last year. For example, spending for domestic budget accounts, such as Energy, Housing and Urban Development, Interior, General Revenue Sharing, Small Business Administration and several independent agencies, declined this year. Most other domestic accounts remained at last year's funding levels. Overall, domestic spending is 3.3 percent lower than last year. As has been the case in recent years, this year's spending growth has been driven by defense, entitlements, farm support, and interest on the national debt. These budget components posted increases of 9.9 percent, 5.4 percent, 36.3 percent and 9.9 percent, respectively.

The Act has imposed fiscal discipline in the budget process. However, G-R-H has its limitations. The Senate's recent action on the 1986 supplemental spending bill, which makes up for unexpected shortfalls, shows that Congress is likely to waive the Act's requirements to appease powerful special interest constituencies. The Act's deficit neutral requirement, which requires that any new spending increases be offset with decreases elsewhere, was waived twice to provide new funding authority for the Rural Electrification Administration (REA) and the Farmers' Home Administration (FHA) programs both of which benefit the powerful rural lobby.

Another limitation of the Act is the premium it places on achieving immediate savings at the expense of aggravating the deficit in the out-years. For example, the REA provision to refinance the revolving fund's high interest loans leads to a $300 million outlay decrease in 1986. However, CBO estimates that the total cost to the Treasury in foregone interest and penalties will eventually reach $2.4 billion.

The Act's major drawback is that it could contribute to efforts to raise taxes. This is because the Act institutionalizes deficit reduction rather than spending reduction per se. In a purely static framework, taxes can be increased to help meet the annual deficit ceiling and, thus, a tax hike is always a viable option. But in reality, the negative effects of increased taxation on economic activity result in less revenue collected than predicted on a static basis. Therefore, the deficit ceilings cannot be met with tax increases.

Nevertheless, both the House and Senate versions of the budget resolution call for $13.2 billion in "unspecified" tax increases for FY 1987 and $45 billion over the next three years. Both versions cut defense spending well below the President's original request for $320 billion in new spending authority and avoid deep reductions in entitlement and domestic discretionary spending.

It must be pointed out that while defense spending shares some of the blame for the increase in total spending in recent years, non-defense spending, which includes entitlement and domestic discretionary spending, is responsible for the underlying growth in the federal budget over the past two decades. Defense spending now reaches about 6 percent of GNP, compared to an average of 9.8 percent in the 1950s and 1960s, while non-defense spending today accounts for 17 percent of total outlays compared to 9.4 percent in the 1950s and 1960s.

However, in an election year, the defense budget is the sacrificial lamb. The Senate and House defense budgets propose $301 billion and $285 billion, respectively, in new spending authority for FY 1987. Congress is using G-R-H to hold the defense budget hostage in exchange for the President's blessing on new taxes. They argue that new taxes are necessary to meet the G-R-H deficit ceiling because domestic spending has been "cut to the bone." Despite this rhetoric of suffering, the fact is that the spending reductions required to meet the ceiling would total a mere 4 percent of the federal budget.

To the surprise of some, the fight for higher taxes has a bipartisan flavor and has the support of many of the Senate Republicans on the budget panel. In large part, this revolt among Senate Republicans is a backlash to the Administration's decision to abandon support for the Senate's courageous budget resolution last year, which proposed to freeze Social Security cost-of-living adjustments, terminate 15 programs and chop $55 billion from the deficit without raising taxes.

Senate Budget Committee Chairman Pete Domenici has repeatedly warned the White House that without new taxes, the sequester will trigger a $17 billion reduction from the $285 billion defense budget set by the House. In an effort to force the President's hand, the Senate Republicans have devised an unusual scheme that would condition the size of the defense budget on revenue increases. Under the Senate proposal, new defense and domestic funding could not occur until legislation was approved to raise revenue levels $7.3 billion above those proposed by the President. In other words, bills providing for increased defense spending would not be sent to the President until he signed the revenue raising bill. According to Domenici, this would tie defense and taxes together "so they would flow simultaneously or not at all." The House Democrats say that they will not go along with the idea unless the President takes the lead on new taxes.

These efforts to force the President to accept tax increases have only strengthened his resolve. In a recent press conference, Reagan said, "I'll say it as often as it takes—I'll veto any tax hike that comes across my desk." Apparently, the House Democrats are believers. They have put together a tentative version of the House budget that would exclude revenues above what the President requested in his FY 1987 budget.

The Budget Can Be Salvaged

Contrary to conventional wisdom, the President and the anti-tax proponents in Congress, mainly the House Republicans, can salvage the FY 1987 budget and meet the G-R-H targets *without raising new taxes.*

Most budget process participants, including OMB director Jim Miller, expect the Supreme Court to uphold the lower court's decision and rule against the G-R-H sequester. The Court is expected to rule that the Comptroller General's involvement in the Presidential sequester process is a violation of the constitutional separation of powers. The fallback mechanism would require Congress to approve the across-the-board cuts by joint resolution and send the resolution to the President for his signature. But this mechanism threatens to be ineffectual because independent action by the House, the Senate, or the President would nullify the entire sequestering process.

Moreover, preliminary estimates of the size of the sequester and its ramifications for defense and domestic spending indicate that the Congress and the President are unlikely to approve the sequester. Under CBO's economic and budget assumptions made in February, the G-R-H sequester would indiscriminately cut spending by $16.6 billion. According to CBO chief Rudolph Penner, a $16.6 billion sequester would result in a 4.5 percent reduction in defense programs and a 5.7 percent reduction in non-exempt domestic programs. Defense personnel levels would be severely cut back with a reduction of 350,000 or more active and reserve personnel. Non-defense programs would be subject to real reductions because, assuming no fiscal appropriations bills are enacted, there will be no programmatic adjustments for inflation next year.

In the likely event that the sequester is rejected, the President would have the upper hand in shaping the budget because defense would not be held hostage to new revenues. As one approach, the President can pursue an active veto strategy in the appropriations process. While Reagan has been reluctant to do this in the past, the G-R-H framework provides him with the political justification to employ the veto more often. The President can argue that he is only forcing Congress to abide by the deficit mandates that they set for themselves. The veto can be an effective weapon in controlling spending because it requires a two-thirds vote of Congress to override. But the Administration may be reluctant to pursue this strategy because the political repercussions of deep cuts in popular domestic programs may jeopardize Republicans, particularly in the Senate, seeking reelection in November.

Another strategy being discussed is to use the projected revenue "windfall" in the Senate's tax reform bill. This bill leads wide annual revenue fluctuations over the next five years. CBO estimates that it would reduce the budget deficit by $7.4 billion in FY 1986 and $22.4 billion in FY 1987. However, the bill then would *add* to the deficit by $21.2 billion in FY 1988, $21.5 billion in FY 1989, and $800 million in FY 1990. In other words, this strategy merely postpones the problem until 1988.

Nonetheless, if the FY 1987 tax reform revenue windfall is combined with the minor spending reductions in the budget resolution, the FY 1987 deficit would be $134.7 billion – substantially below the FY 1987 G-R-H deficit target of $144 billion. Senate Majority Leader Bob Dole has expressed some interest in this approach, but Senator Domenici is vehemently opposed to it. He warns that using the early revenue surpluses for deficit reduction would aggravate the deficit problem in the out-years.

The vote to raise the public debt ceiling to $2.3 trillion offers perhaps the best opportunity to salvage the federal budget. Last year, Senators Phil Gramm (R-TX), Warren Rudman (R-NH), and Ernest Hollings (D-SC) used the debt ceiling bill as a vehicle to pass the G-R-H bill. This year, the three principle sponsors may use the debt ceiling bill as a vehicle to repair the sequester process. They plan to modify the sequester process by making the Comptroller General solely accountable to the President and, thus, avoiding the constitutional separation-of-powers problem. Other possible amendments to the debt ceiling bill include the mechanisms that would restore Presidential budgetary power such as the line-item veto and the "enhanced" rescission authority. Another strategy would be to attach a $38.8 billion spending reduction package as an amendment to the debt ceiling bill. This debt ceiling strategy provides fiscal conservatives with the opportunity to force Congress to accept fiscally responsible measures. The public views G-R-H as a congressional promise to cut deficit spending and, thus, raising the public debt without fixing G-R-H or complying with the deficit mandates may be politically damaging in an election year.

Conclusion

The Gramm-Rudman-Hollings Act has had a substantial impact on reducing the real growth of federal expenditures. The major drawback of the Act is the increased pressure for raising taxes to meet the annual deficit targets. The standoff between the Administration and Congress on defense and taxes will probably drag on throughout the summer and climax in an omnibus continuing resolution this fall. The interplay of the Supreme Court's decision on the sequester, an active veto strategy by the President, revenue windfall from tax reform and amendments to the debt ceiling bill may provide the Administration and Congress with the opportunity to reduce the deficit without raising new taxes this year. However, both defense and domestic spending will be reduced. The fiscal year 1987 deficit may not turn out to be $144 billion when CBO and OMB make their final estimates, but federal spending growth should remain in check.

Next year, the budget arithmetic becomes even more difficult as Congress faces the task of reducing the deficit to $108 billion. There will be limited opportunities to achieve further spending cuts if Social Security, Medicare and other entitlement spending is again deemed untouchable. The Administration will argue that the defense budget will have been reduced in real terms for two consecutive years while Congress will claim that domestic programs have been pared to the bone. This could add up to a big tax increase. That's why the privatization option – shifting the provision of government programs and services to the private sector – may be the only solution to shrinking the budget deficit without jeopardizing economic growth.

TRENDS IN COMMERCE NOTES ON TABLE II JUNE/JULY 1986

by
*Martin Lefkowitz**

Gross National Product (GNP) – The revised estimate of Gross National Product – the total value of goods and services produced – shows that first quarter real (inflation-adjusted) GNP rose at an annual rate of 2.9 percent, more than four times the growth rate for the fourth quarter of 1985. Consumer spending, which had dragged down the fourth quarter performance, rebounded in the first quarter growing at a 3.8 percent rate. However, a lower rate of fixed investment was reported in the first quarter as a result of cutbacks in the energy industry. Exports increased by $5.8 billion, while imports rose by only $3 billion.

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The Services Sector–Employment in service sector establishments increased by 199,000 jobs in May and is now 2.6 million jobs above its year-ago level. This compares with an increase of 39,000 jobs in the goods-producing sector during the last year. Over 98 percent of the job growth in the economy during the past year has been in services industries.

Consumer purchases of services increased by 0.5 percent in May. Major domestic airlines reported that revenue passenger miles flown, that is, the number of passengers multiplied by the miles flown by each passenger, reached 22.8 billion in May, an increase of 9.7 percent from its year-ago level. For the first five months of 1986, domestic passenger traffic on U.S. scheduled airlines was up 9.1 percent from the same period a year ago. International passenger traffic collapsed in the wake of fears of terrorism, experiencing a 14.8 percent decline in May compared to May of last year.

Money Supply–The nation's money supply–as measured by M1, currency in circulation plus demand deposits–increased by 1.9 percent in May and was nearly 14 percent above its year-ago level. This is considerably above the Fed's target range of three to eight percent.

Employment–The civilian unemployment rate inched up 0.2 percentage points in May to 7.3 percent, the same level as in May of 1985. The rise in the unemployment rate was due to a strong increase in the labor force for the month, (430,000 new entrants). The number of nonagricultural payroll jobs–as measured by the monthly survey of business establishments–increased by 149,000 in May. Civilian employment–as measured by the monthly survey of households–increased by 218,000 persons and now stands at 109.1 million jobs (after seasonal adjustment).

Prices–The Consumer Price Index for all urban consumers (CPI-U) increased by 0.2 percent in May following three consecutive months of declining prices. The string of three monthly decreases resulted in the largest decline in the CPI in the last 37 years. The consumer price index is now only 1.6 percent above its year-ago level. The change in the the direction of the index was due to a 2.5 percent increase in gasoline prices, following three months of decreases during which gasoline prices dropped by 26.5 percent. Excluding energy, the CPI-U actually increased by only 0.2 percent in May, compared to a 0.4 percent increase in April. This indicates that the decline in energy prices are working their way into other sectors of the economy. If energy prices remain at current levels, we should see stable prices during the months ahead.

Wholesale prices of finished goods increased in May for the first time in 1986. In contrast, for the first four months of the year, finished goods prices declined an average of one percent per month–an annual rate of 12 percent. Most of the upturn in finished goods prices was due to an increase in energy goods and food prices. However, prices of energy goods at the intermediate level of processing continued to decline in May.

Crude goods prices increased 2.3 percent in May. However, all major categories of crude goods were significantly below their levels of a year ago, except for construction materials. The largest decline in the crude goods category was in crude petroleum which registered a 51.6 percent price drop compared to its year-ago level.

Housing Starts–Privately owned housing units were started at a seasonally adjusted annual rate of 1,888,000 in May, a decrease of 7.4 percent from the April level. Housing starts were 12 percent above the May 1985 level, and in the first five months of the year were 9 percent higher than the comparable period in 1985. Building permits, an indicator of future activity in the home building industry, were down five percent for the month.

Corporate Cash Flow and Profits–Corporate profits have been sluggish for the past year. Profits decreased by 5 percent between the first quarter of 1985 and the first quarter of 1986. Economic profits, which takes into account economic depreciation and adjusts for changes in inventory valuation, were up 11.4 percent for the quarter from their year-ago level. However, corporate cash flow, which includes depreciation allowances, increased nearly 9.1 percent over that same period, indicating a strong cash position in the corporate sector.

Industrial Production–Industrial production decreased by 0.6 percent in May, following a 0.4 percent increase in April. The drop in output was widespread, with the most significant declines in oil and gas well drilling materials, and autos and business equipment. The total index was two percent below the level of January and only 0.1 percent above a year ago.

The capacity utilization rate in manufacturing decreased to 78.8 percent in May from 79.2 percent in April. The decline was attributable to a significant drop in auto production where the operating rate for the industry fell from 80.4 percent in April to 75.0 percent in May. Capacity utilization in both electrical and nonelectrical machinery dropped below 70 percent in May.

Productivity–Nonfarm business productivity increased at a seasonally adjusted annual rate of 3.6 percent in the first quarter of 1986. This was the result of a 4.5 percent increase in output, and a 0.9 percent increase in hours worked. Manufacturing productivity rose at a 2.2 percent

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Mar/86	240.7	240.6	238.5	0.0	0.9
Gross National Product ($B)	I/86	4,115.7	4,059.3	3,917.5	1.3	5.0
Gross National Product (82$B)	I/86	3,619.9	3,590.8	3,547.8	0.7	1.9
Money Supply (M1) ($B)	May/86	658.4	646.1	582.5	1.9	13.6
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	May/86	2,710.7	2,685.5	2,575.5	0.9	5.2
Personal Consumption Expenditures (82$B)	Apr/86	2,376.8	2,364.5	2,292.3	0.5	3.6
Disposable Personal Income ($B)	May/86	2,937.6	2,943.5	2,857.5	−0.2	2.8
Disposable Personal Income (82$)	Apr/86	2,605.2	2,568.6	2,530.9	1.4	2.9
Personal Savings Rate (%)	May/86	4.2	5.3	6.8	−1.1[b]	−2.6[b]
Civilian Employment (millions)	May/86	108.8	108.6	107.0	0.1[c]	1.6[c]
Civilian Unemployment Rate (%)	May/86	7.3	7.1	7.3	0.2[b]	0.0[b]
Average Hourly Earnings	May/86	$8.74	$8.71	$8.52	0.3	2.6
Consumer Price Index (All Urban, 67=100) [a]	May/86	326.3	325.3	321.2	0.3	1.5
Purchasing Power of the Dollar (67=$1.00) [a]	Apr/86	0.307	0.307	0.315	0.0	−2.5
Prime Interest Rate (%) June 18, 1986		8.5	9.0	10.0	−0.5[b]	−1.5[b]
Retail Sales ($B)	May/86	117.1	117.1	114.0	0.0	2.7
SERVICES SECTOR						
Employment in Services (Millions)	Mar/86	74.7	74.4	71.9	0.4	1.4
Consumer Purchases of Service ($B)	May/86	1,393.8	1,386.5	1,296.8	0.5	7.4
Consumer Purchases of Service (82$B)	Apr/86	1,147.7	1,146.5	1,112.0	0.1	3.1
Domestic Revenue Passenger Mileage Flown						
Major Airlines (Billions) [a]	May/86	22.8	21.9	20.8	−6.2	9.7
BUSINESS PROFITS AND OUTPUT						
Corporate Profits and Cash Flow ($B)						
Before Tax	I/86	216.6	233.8	228.0	−7.3	−5.0
Profits Tax Liability	I/86	79.7	87.1	83.4	−8.4	−4.4
Tax Liability as a Percent of Profits	I/86	36.7	37.2	36.5	−15.7[b]	−9.4[b]
After Tax	I/86	137.0	146.7	140.6	−6.6	−2.5
Net Cash Flow	I/86	405.6	415.8	371.6	−2.4	9.1
Industrial Production (77=100)	May/86	124.2	125.0	124.1	−0.6	0.1
Capacity Utilization Rate (Mfg.) (%)	May/86	78.8	79.4	80.3	−0.5[b]	−1.5
New Housing Starts (thou. units)	May/86	1,888.0	2,039.0	1,684.0	−7.4	11.6
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77=100)	I/86	170.3	170.9	165.3	−0.4	3.0
Unit Nonlabor Costs (nonfarm) (77=100)	I/86	161.9	157.7	158.8	−2.7	2.0
Producer Price Indices (67=100) [d]						
Crude Materials	May/86	272.8	278.9	318.9	2.3	−5.5
Intermediate Goods	May/86	306.8	307.0	319.5	−0.2	−0.7
Finished Goods	May/86	289.0	286.9	292.1	0.8	1.4
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67=100)	Apr/86	593.2	596.7	598.5	−0.6	−0.9
Federal Gov't Gross Debt Outstanding ($B) [a]	Feb/86	1,983.4	1,966.8	1,702.8	0.8	16.5
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	I/86	377.4	367.8	379.6	2.6	−0.6
Imports of Goods & Services ($B)	I/86	477.2	481.2	421.9	−0.8	13.2
Balance on Goods & Services ($B)	I/86	−99.8	−113.4	−42.3	12.3	135.9
WHAT'S AHEAD?						
Index of Leading Indicators (67=100) [a]	Apr/86	179.2	176.6	166.7	1.5	7.4

NOTE: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted.
[b] Percentage point difference.
[c] January data is a new series that is not comparable to previous data.
[d] Index number not seasonally adjusted, percent change seasonally adjusted.

annual rate in the first quarter, and manufacturing output rose by 2.3 percent, while hours worked increased by 0.1 percent.

Interest Rates—The prime interest rate was reduced from 9 to 8.5 percent on April 21, 1.5 percentage points below its level of last year. The prime lending rate is now at the lowest it has been since August 1978 and 13 points below the 21.5 percent peak reached in December 1980. Three- and six-month Treasury bill rates were both near 6.1 percent on June 18 after falling below the six percent range in mid-April. Thirty-year Treasury bonds which had traded at about 7.4 percent in mid-April bounced back up to 7.8 percent at the end of May, but have since fallen to 7.4 percent.

Federal Spending—The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, declined to 593.2 in April (1967=100), a 0.6 percent decrease from the previous month and 0.9 percent below the level of April 1985. Federal receipts for the first seven months of fiscal year 1986 increased by 3.1 percent, while expenditures for the same period rose by 3.8 percent. The federal deficit for the first seven months of fiscal year 1986 was $126.4 billion compared to $118.6 billion during the same period in fiscal year 1985.

Personal Savings—The personal savings rate was 4.2 percent of after-tax income in May, lower than the 5.3 percent saving rate in April, and 6.8 percent saving rate in May of 1985. The low rate of personal savings has been attributed to a number of factors, including the rising stock market that has swelled household balance sheets and left persons with less of a perceived need to save as much from their current income.

Retail Sales—Retail sales were virtually unchanged in May following a revised 0.4 percent increase in April. Sales were 2.7 percent above their year-ago level. The May decline was due to lower gasoline prices, which pushed gas station sales down by 2 percent for the month, and more than 9 percent since March. Retail sales have been virtually unchanged since December and are still below the peak reached in September of 1985. Reflecting strong housing activity, May retail sales were strongest in the furniture, home furnishings and equipment stores.

Trade Deficit—On a goods and services basis, the trade deficit in the first quarter of 1986 was $99.8 billion, significantly below the $113 billion reported in the fourth quarter of 1985. The drop in the trade deficit in the first quarter was due to lower oil prices.

What's Ahead—The composite index of leading indicators, designed to predict future movements in aggregate economic activity, jumped 1.5 percent in April, the best single month performance since October, 1983. Seven of the 11 indicators available were up, three were down, and one was unchanged. The contributors to the April increase in the leading indicators were money supply, change in credit outstanding, manufacturers new orders for consumer goods and materials, stock prices, net business formations, initial claims for unemployment and insurance contracts, orders for plant and equipment, stock prices, money supply, net business formations and slower deliveries by vendors, indicating a backlog of orders.

FOREIGN DIRECT INVESTMENT RISES IN U.S.

A recent report by the Department of Commerce found that foreign direct investment in the U.S. grew 11.2 percent in 1985, compared with a 20 percent increase in 1984. The slowdown reflected slower economic growth and the drop in U.S. interest rates.

Foreign direct investment rose to $182.95 billion last year from $164.58 billion in 1984. At the same time, the depreciation of the dollar against most major currencies helped cause U.S. direct investment abroad to rise 9.2 percent in 1985, after advancing 2.8 percent in 1984. The Department of Commerce defines direct investment as the book value of an investor's equity in, and net outstanding loans to, a foreign affiliate.

HOW POOR IS POOR?

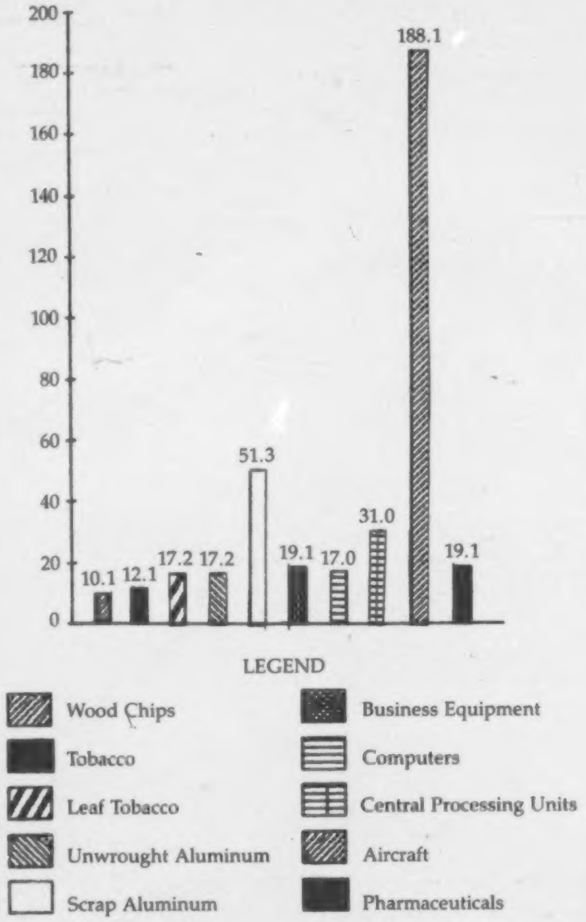
The Census Bureau has calculated the estimated new poverty thresholds for 1985, which measures how many people fell below the government's official poverty line last year. In 1984, 14.4 percent of the population, or 33.7 million people, were below the poverty line. The estimated poverty lines for families of different sizes in 1985 were about 3.6 percent higher than in 1984.

Families and persons are classified as living in poverty if their cash income falls below the official poverty line. Noncash income, such as food stamps, medical services and school lunches, is not counted.

The 1985 Poverty Cutoffs Were Estimated as Follows:

One person under age 65:	$5,590
One person age 65 or over:	$5,160
Two persons, head of household under 65:	$7,230
Two persons, head of household 65 or over:	$6,510
Three persons:	$8,570
Four persons:	$10,990
Five persons:	$13,010
Six persons:	$14,710
Seven persons:	$16,670
Eight persons:	$18,600
Nine or more persons:	$22,010

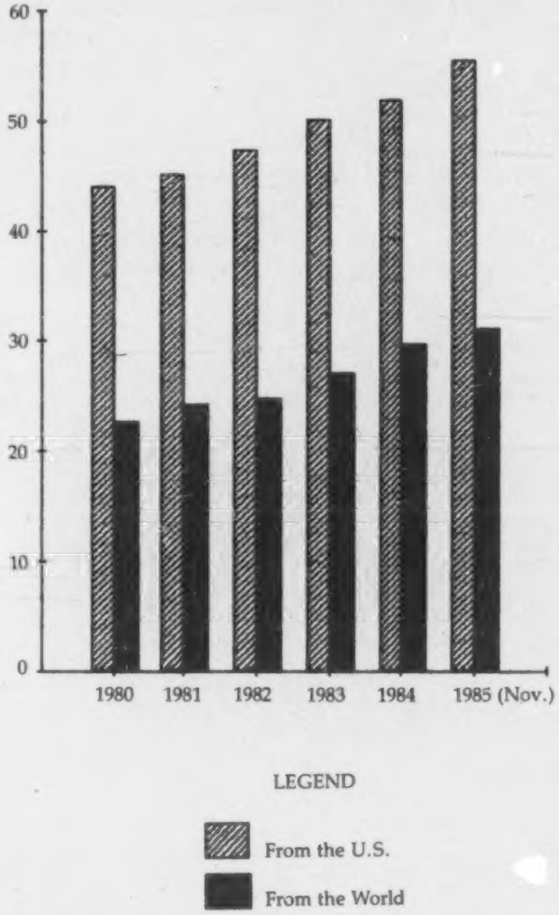
MAJOR INCREASES IN U.S. EXPORTS TO JAPAN January–October 1985[1]



[1] Percentage increase over same period previous year.

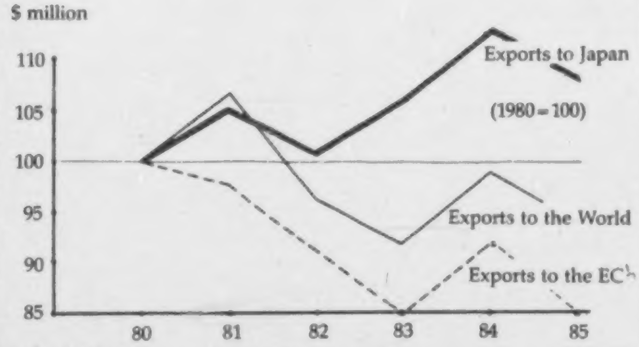
Source: Look Japan, April 10, 1986

JAPANESE IMPORTS OF MANUFACTURED PRODUCTS (Percent of Total Imports)



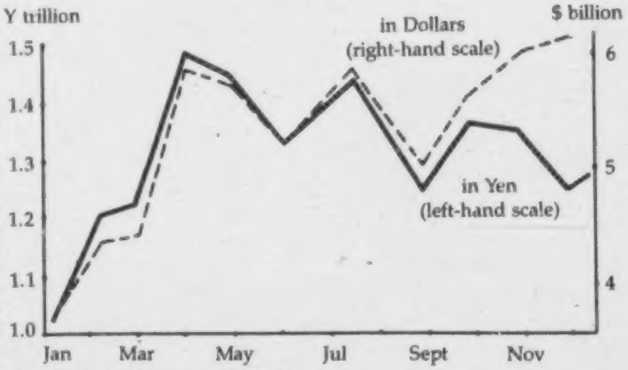
Source: Look Japan, April 10, 1986

U.S. EXPORT PERFORMANCE 1980–85



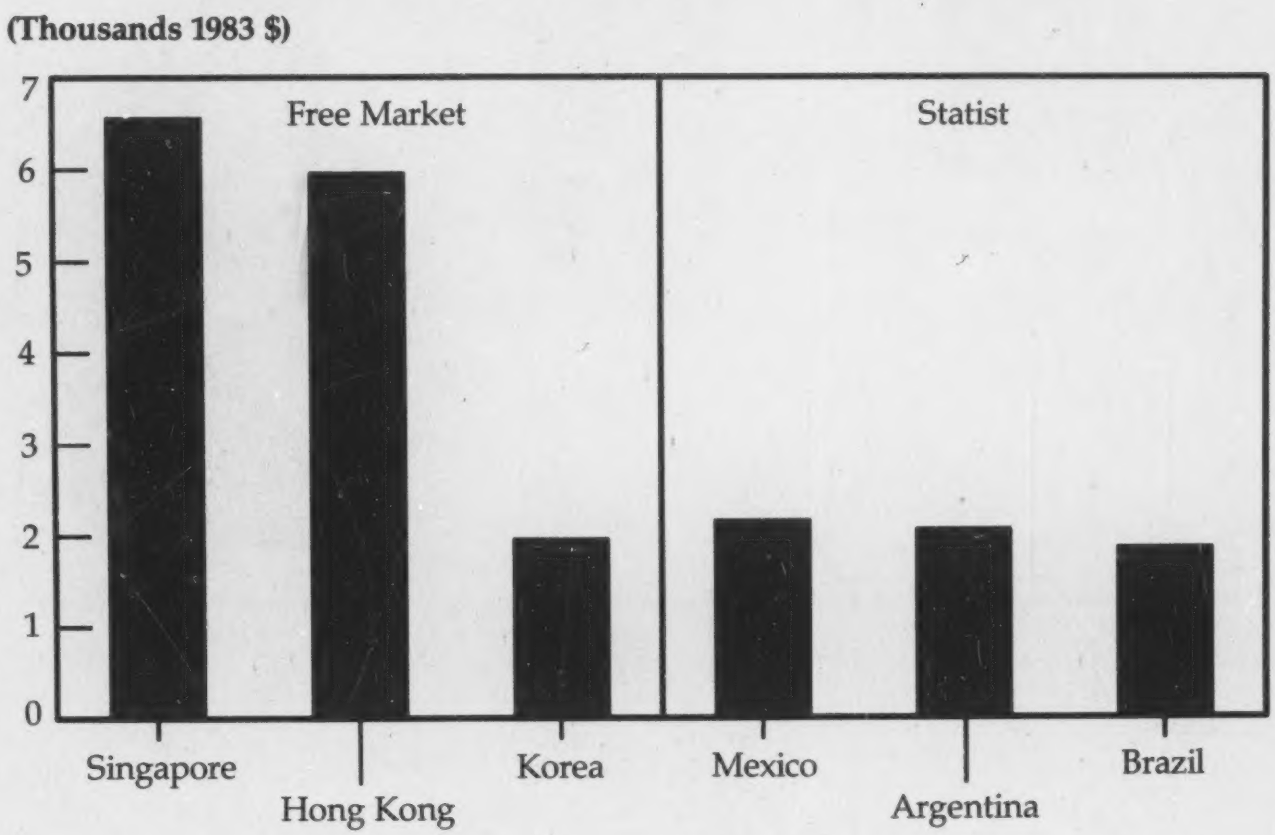
Source: Look Japan, April 10, 1986

JAPANESE EXPORTS TO THE U.S. 1985

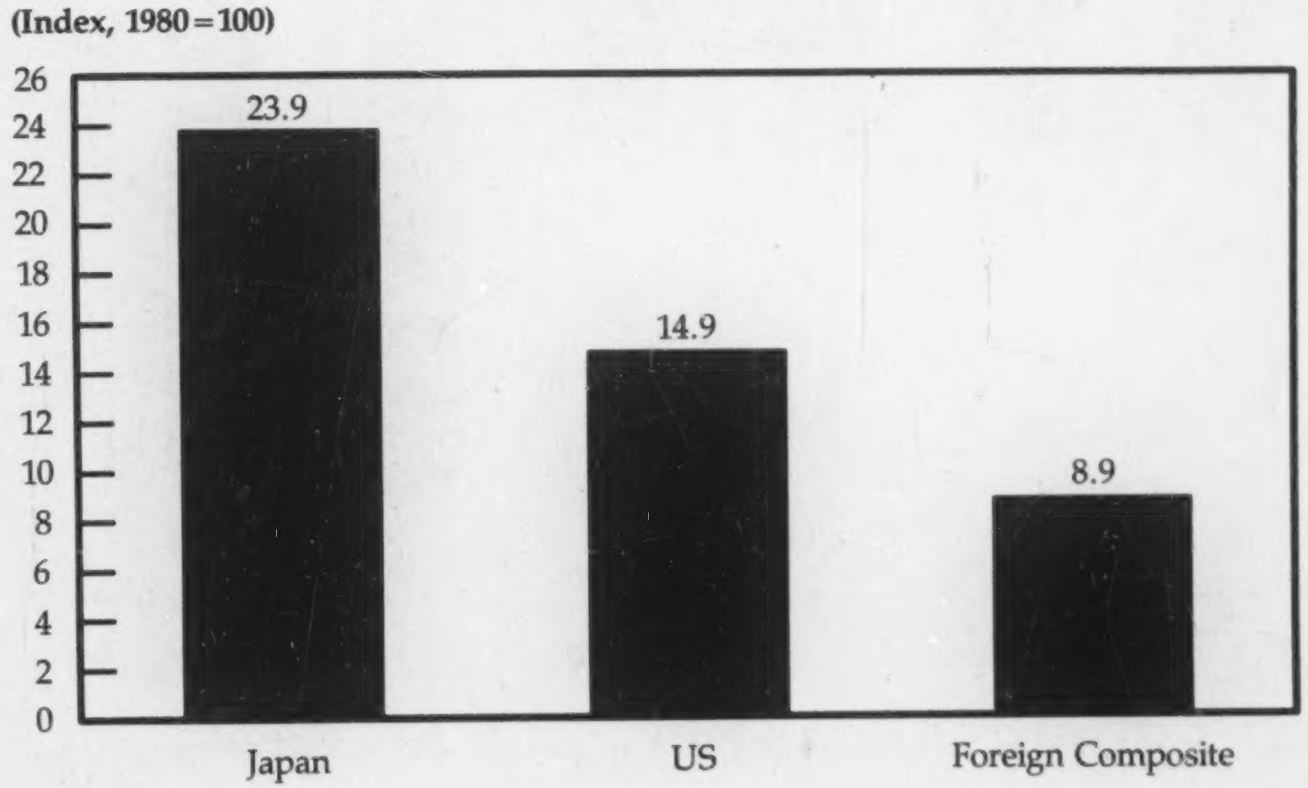


Source: Look Japan, April 10, 1986

Per Capita GNP in Free Market and Statist Economies



Increase in Industrial Production Since 1980



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ECONOMIC OUTLOOK

Chamber of Commerce of the United States
August/September 1986

TAX REFORM AND THE OUTLOOK

by

Richard W. Rahn and Graciela Testa-Ortiz

In spite of the fact that the recent revision to the National Income and Product Accounts shows that the domestic economy remains basically strong (real GNP rose by 3 percent during the first half of 1986 compared to the first half of 1985), great uncertainty regarding the outlook for the remainder of this year and next continues. The latest consensus forecast shows that real GNP is anticipated to rise by 2.2 percent and 2.7 percent during the third and fourth quarters of this year, respectively, compared to forecast increases of 3.2 percent and 3.1 percent, respectively, in January. According to the consensus, the outlook for 1987 seems to be even more uncertain. The predictions of the 52 forecasters surveyed by *Blue Chip Economic Indicators* range from an increase in real economic activity of 4.7 percent, to threats of imminent recession as reflected by predictions of a 0.7 percent decline in real GNP growth at the bottom of the *Blue Chip* range.

Beyond this year, the pessimism reflected in the average forecast for 1987 (the average forecast fell to 3 percent in August from 3.3 percent in July and 3.5 percent in June), appears to be directly linked to tax reform. In July, the *Blue Chip* forecasters were asked which factors would have the most unfavorable impact on 1987 economic growth. Eighty-four percent of the respondents stated that tax reform, particularly the reduction in business incentives, was the most unfavorable factor in the 1987 scenario.

The Impact of Tax Reform

Now that the House-Senate Conference Committee has reached a compromise, it is worthwhile to reiterate some of the findings regarding the impact of tax reform. In the December 1985 issue of *Economic Outlook*, we reported on the findings of a study, performed by the consulting firm of Laurence H. Meyer and Associates (LHM&A), on the impact of the House version of the bill. That study concluded that implementation of the House proposal would result in a cumulative decline in real gross national product of $145 billion between 1986 and 1991. In the June/July 1986 issue of this publication we noted that although the Senate version of the bill would have an initial negative effect on the economy, it was, nevertheless, a significant improvement over the House version and would have a positive influence in later years. In an effort to improve the final bill and diminish its initial negative impact, we suggested that four changes be made to ensure a smoother transition period. These four changes were as follows: 1) the tax rates should be reduced at the same time as the tax base is broadened; 2) the capital gains tax rate needs to be reduced; 3) the minimum tax needs to be reformed; and 4) the investment tax credit should not be repealed retroactively.

Of these four recommendations, only the timing of the rate cuts was altered by the House-Senate Conference Committee. The individual rate cuts will take place on March 15, 1987, while the corporate rate cuts will still take place on July 1 of next year.

In assessing the outlook for the next two and a half years, therefore, the likely impact of the outcome of the tax reform compromise needs to be addressed. According to the analysis prepared by LHM&A, the House version of the bill signifies declines in real GNP (from a base simulation that did not include tax reform), of 0.3 percent and 0.8 percent in 1987 and 1988, respectively. The Senate version, on the other hand, implies declines

IN THIS ISSUE

Tax Reform and the Outlook .... p. 1
Forecast Table .... p. 3
The Trade Conundrum .... p. 4
Changing Perspective on Bank Failures .... p. 7
Comparable Worth: Is the Value of a Job Determined by Who Does It? .... p. 9
Trends in Commerce .... p. 13

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from the current law baseline of only 0.1 percent and 0.4 percent, respectively. If the Conference Committee report becomes law, the outcome is likely to be somewhere in between those two ranges. In sum, there will be transitional costs to the economy over the next two years which will reduce GNP slightly from the baseline projection. From 1989 onward, the new tax system ought to be a net plus to the economy. The Congress still has the opportunity to guarantee a long run positive outcome to the tax reform legislation if it modifies the obvious major negatives in the tax bill, namely, the treatment of capital gains and capital cost recovery.

The Expansion Measures Up Well To Past Experience

The pending tax reform bill is not the only factor affecting the wide range of forecasts for the remainder of this year and next. Thirty-four percent of the respondents to the *Blue Chip* survey regarding unfavorable factors in next year's outlook, stated that the business cycle was aging, that is, that since the expansion is already 46 months old it is doomed to die of old age. The reality, of course, is that growth periods die from policy mistakes, not old age. Given the continuing debate regarding the strength and longevity of the current phase of the cycle—a debate which began in 1983 with many forecasters anticipating an "anemic and short-lived" upturn—it seems an appropriate time to pause and re-examine the economy's performance thus far.

Despite earlier predictions, this recovery has turned into the third longest expansion in postwar history and the second longest peacetime expansion since 1945. Already into its 16th quarter, it is surpassed only by the 1975–1980 expansion which lasted 20 quarters, and the 1961–69 expansion which lasted 35 quarters. An examination of the data shows that while real GNP has increased at an average quarterly rate of 0.8 percent during the past ten years (1976:2 to 1986:2), the comparable figure for the past 15 quarters was 1.1 percent. And despite the second quarter's weakness, economic activity during the first half of the year was 2.9 percent above the comparable period in 1985. A comparison of this recovery with the 1960 and 1975 episodes shows that although it is lagging the previous experience, domestic demand remains remarkably strong, surpassing past performance in some sectors.

The apparent weakness, relative to the previous expansions, stems largely from the global trade imbalance which is reflected in the performance of U.S. imports and exports. Indeed, real GNP minus net exports has performed slightly better than past experience. The swings in the real GNP growth rate during the past five quarters can be explained by swings in imports. In some cases, these swings were offset by opposite changes in inventories. Only in the most recent quarter do we see that inventory change and import growth both worked to the disadvantage of real GNP (see Forecast Table).

Domestic demand (GNP minus net exports) during the first half of 1986 was 4 percent above its year earlier level and 21 percent higher than the recession trough (compared to a 20.9 percent average increase during the past two recoveries which lasted this long).

TABLE 1
CYCLICAL EXPERIENCE*
(Percent)

Cycle Trough	GNP	Consumption	Investment
1960:4	20.0%	17.6%	25.6%
1975:1	20.4	18.6	67.1
Average	20.2	18.1	46.4
1982:3	16.1	17.5	92.1

Cycle Trough	Nonresidential Investment	Producers' Durable Equipment	Nonresidential Structures
1960:4	25.6%	37.2%	13.9%
1975:1	31.7	39.7	17.9
Average	28.7	38.5	15.9
1982:3	27.2	48.2	-5.9

Cycle Trough	Exports	Imports	GNP Minus Net Exports
1960:4	29.0%	26.7%	19.9%
1975:1	28.1	45.5	21.8
Average	28.6	36.1	20.9
1982:3	1.2	47.9	21.3

*Increase in real activity during the first 15 quarters of a cyclical upturn.

Despite repeated warnings regarding the sustainability of strong consumer spending, real consumption continues to support economic activity as has been the case since the beginning of the expansion. The latest data shows that real consumer spending rose at an annual rate of 6.5 percent during the second quarter, significantly above the 0.6 percent rise in total output. However, the performance of consumption is not out of line with previous experience. It has risen by 17.5 percent since the recession trough in the third quarter of 1982, compared to an average increase of 18.1 percent at this stage in previous expansions. Although consumer debt as a proportion of disposable income continues to scale new highs, continued improvements in employment (a record number of adults are now employed), and in household

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Dr. William Orzechowski, Director of Federal Budget Policy.
Ms. Rajni Bonnie Ohri, Economist.
Ms. Lyn Maness, Production Coordinator.

TABLE I
UNITED STATES ECONOMIC OUTLOOK 1986-1988
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates.)

	QUARTERS									YEARS			
	Actual			Forecast						Actual	Forecast		
	85:4	86:1	86:2	86:3	86:4	87:1	87:2	87:3	87:4	1985	1986	1987	1988
GROSS NATIONAL PRODUCT													
Real GNP	2.1	3.8	0.6	3.5	3.6	2.8	3.4	2.9	2.6	2.7	2.8	3.0	4.0
Consumption	1.7	3.6	6.5	3.1	3.0	2.2	2.4	2.1	1.3	3.5	3.9	2.7	3.3
Residential Investment	3.4	11.0	13.5	2.3	2.2	-3.0	-4.4	-0.3	1.0	3.9	8.2	0.1	4.1
Nonresidential Investment	12.5	-15.1	-2.3	2.2	5.0	2.4	2.0	3.0	1.2	9.3	-0.6	2.5	4.4
Equipment	18.7	-19.0	19.9	1.1	4.8	1.9	1.0	2.4	0.0	10.1	4.1	3.1	4.0
Structures	0.3	-10.8	-38.6	4.7	5.4	3.4	4.7	4.6	4.0	7.7	-10.3	0.9	5.4
Exports	8.2	7.1	-5.6	16.8	9.1	9.9	10.8	11.3	11.5	-2.0	3.5	10.1	10.3
Real Net Exports (82$B)	-132	-125.9	-150.5	-144.6	-139.5	-131.8	-122.2	-111.7	-99.5	-108.2	-140.2	-116.3	-89.7
Imports	23.3	0.2	16.5	7.3	2.5	1.2	0.6	0.5	-0.5	3.8	9.5	2.8	3.0
Government Purchases	22.7	-27.5	11.9	7.2	22.2	-19.1	-0.9	5.2	15.6	10.9	3.5	1.1	-0.2
Final Sales	2.7	-1.3	3.8	3.7	5.3	0.7	2.8	3.6	3.8	4.2	2.5	3.0	3.8
Change in Business Inventories (82$B)	-5.2	39.9	11.6	14.8	-0.2	18.9	24.6	18.1	7.6	9.0	16.5	17.3	28.6
Industrial Production	2.0	2.0	-0.9	1.8	5.7	3.7	5.3	4.2	3.8	2.6	1.7	3.9	6.2
Total New Car Sales (mill.)	10.3	11.0	11.0	10.9	10.6	10.8	11.0	11.0	10.8	11.2	10.9	10.9	11.1
Domestic Car Sales (mill.)	7.0	7.8	8.1	8.0	7.7	7.9	8.1	8.1	7.9	8.2	7.9	8.0	8.2
New Housing Starts (mill.)	1.77	2.00	1.91	1.88	1.89	1.75	1.76	1.76	1.77	1.74	1.92	1.75	1.93
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	7.0	7.1	7.2	7.0	6.9	6.9	6.8	6.7	6.9	7.2	7.1	6.8	6.3
Compensation	3.7	3.1	2.3	2.5	2.6	3.6	2.8	2.9	3.1	4.0	3.0	2.9	3.6
Productivity	-3.5	4.3	1.9	1.0	2.3	0.8	1.3	0.8	0.7	0.5	1.4	1.2	1.4
Unit Labor Costs	7.4	-1.2	0.3	1.5	0.3	2.8	1.4	2.0	2.3	3.7	2.7	2.2	2.5
Consumer Price Index	4.3	1.4	-1.7	2.1	2.4	2.3	2.6	2.6	3.3	3.5	1.8	2.2	3.4
Implicit GNP Deflator	3.6	2.5	2.5	2.2	2.2	2.2	2.2	2.4	2.6	3.3	2.6	2.2	3.1
Prime Interest Rate (%)	9.5	9.4	8.6	8.1	7.6	7.5	6.8	6.4	6.2	9.9	8.4	6.7	6.1
3-mos. Treasury Bill Rate (%)	7.2	7.0	6.1	5.6	5.1	5.0	4.5	4.5	4.4	7.5	6.0	4.6	4.5
Corporate Bond Rate (%)	10.6	9.6	9.0	8.8	8.4	8.3	7.9	7.7	7.6	11.4	9.0	7.9	7.1
Real Personal Disposable Income	2.8	6.4	7.3	-1.1	1.4	3.4	1.6	1.6	0.9	1.4	3.4	2.0	3.0
Profits from Current Production ($B)[1]	189.2	207.3	200.1	194.0	209.5	171.4	174.1	200.8	201.7	188.9	202.2	187.0	217.1
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts										736	766	836	908
Unified Outlays										937	989	1015	1070
Unified Deficit										-201	-223	-179	-162

[1] After-tax corporate profits with inventory valuation and capital consumption allowances.

[2] Unified budget figures on a fiscal year basis.

Source: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's outlook contains the July revisions to the National Income Accounts for the second quarter of 1986. The forecast incorporates provisions of the tax reform plan. These include: reductions in personal and corporate marginal income tax rates, repeal of the ITC, less generous depreciation allowances for structures, and elimination of the preferential treatment of capital gains income. These changes are implemented consistent with the static revenue estimates reported by the Joint Committee on Taxation. The nation's money supply (M1) is assumed to grow by 11.7 percent in 1986, 7.3 percent in 1987, and 6.7 percent in 1988. The trade weighted exchange value of the dollar falls by 15.2 percent in 1986, 4.5 percent in 1987, and stabilizes in 1988. The price of imported oil averages $14.00 per barrel. The federal minimum wage is not expected to increase.

assets, and low interest rates, have raised consumer buying attitudes to their highest level in 40 years.

Spurred by low interest rates and increased incomes, which translates into improved housing affordability, residential investment continues to rise impressively. Since the end of the recession, residential investment has increased by 92 percent, surpassing previous episodes by a wide margin.

Nonresidential fixed investment continues to perform well despite the uncertainty created by the tax reform debate. The stellar performer in the nonresidential investment sector is investment in producers' durable equipment. Despite weakness in some sectors, overall growth in this category of investment has surged by 48 percent compared to an average improvement of only 38.5 percent during past recoveries. The strength of equipment investment has offset weakness in nonresidential structures, contributing to an overall improvement in nonresidential fixed investment of 27 percent compared to a recovery increase of 25.6 percent during the comparable period of the 1960 expansion and 31.7 percent in 1975.

Other measures of economic health also remain positive. Inflation, as measured by the implicit deflator for real GNP, has risen by 12.9 percent compared to an average recovery increase of 17.7 percent and the improvement in nonfarm output per manhour, at 7.1 percent, compares favorably with the 1975 period. The performance of the manufacturing sector has been even more impressive and unit labor costs have actually declined during this recovery.

Moreover, while the 0.6 percent increase in real GNP posted during the second quarter seems, to some analysts, to foreshadow further weakness in U.S. economic activity, a closer examination of the data shows that this is far from the case. As noted previously, second quarter growth was eroded by a 16.5 percent increase in imports and a $28.3 billion decline in inflation-adjusted inventory accumulation. The turnaround in inventory accumulation represents a correction from the surge in unplanned stockbuilding during the first quarter, which resulted from a 1.3 percent decline in real final sales. This correction, we believe, will have run its course by the end of the year and thereafter contribute to enhance real growth. The surge in real imports is accounted for by a significant rise in petroleum imports to more than 7.8 million barrels a day in June, the highest rate since February 1980. The jump in oil imports was in reaction to declines in oil prices which prompted a rebuilding of U.S. oil inventories.

The Current Outlook

According to the Department of Commerce's Bureau of Economic Analysis, the composite index of leading indicators has risen by 2.8 percent during the first half of 1986 and by 6.5 percent over its June 1985 level. Interest rates are now at their lowest level since 1977. Consumer prices have increased by only 1.8 percent during the past twelve months. Nonfarm labor productivity rose at an annual rate of 4.3 percent in the first quarter and 2 percent in the second, following a 0.5 percent increase during 1985. Real personal disposable income increased by 6.4 percent during the first quarter and 7.3 percent during the second quarter. Nonagricultural employment rose by 389,000 in July.

The data presented not only shows that the U.S. economy is performing well, but that prospects for the remainder of the year remain strong. In addition to tax reform, the outlook will be shaped by the impact of low oil prices, the decline in the value of the dollar and low interest rates. The bulk of the initial negative impact on the domestic oil and related industries of the falloff in oil prices has already been felt. During the rest of the year, the economy will get a boost from lower oil prices. Low interest rates will continue to support a strong residential sector. New housing starts, which averaged a strong 1.95 million units during the first half of the year will remain in the 1.9 million unit range. Nonresidential investment is expected to post a 0.7 percent decline brought about by a 10 percent fall in structures. However, investment in producers' durable equipment is expected to continue growing, albeit at a slower pace. Consumer spending is anticipated to grow substantially faster than the overall economy in 1986 and will continue to support economic activity in 1987 and 1988.

While the decline in the dollar has yet to be reflected in the trade data, continued slides in the U.S. currency and stronger overseas demand are expected to foster a turnaround in real net exports during the second half. It must be noted, however, that U.S. demand has singlehandedly kept the world economy afloat. If domestic demand in our major trading partners, particularly West Germany and Japan, remains weak, the decline in the value of the dollar, by itself, cannot be expected to foster growth in U.S. exports (see the article that follows).

THE TRADE CONUNDRUM

by

Graciela Testa-Ortiz

The trade-weighted value of the dollar has fallen by 30 percent since its peak in February 1985. This decline, by making U.S. goods and services comparatively less expensive abroad, was expected to increase foreign demand for U.S. products. Similarly, by making foreign products more expensive at home, it should have reduced domestic demand for imports. As a result, the trade gap was expected to narrow. But this has not happened; U.S. exports have barely risen and imports continue to rise.

There are several reasons why export growth has not yet improved significantly. Two of the major ones are discussed in this paper. First, there is a lag between changes in currency values and their impact on the trade balance. Second, the economies of our major trading partners are in a slump because high real interest rates are suppressing economic activity abroad. As will be shown, stimulative policies in Western Europe and Japan would go a long way toward solving the current trade imbalance.

The J-curve

Part of the explanation for the continuation of the trade imbalance lies in the so-called "J-curve effect." This refers to the fact that export and import volumes do not adjust immediately to changes in prices. The initial impact of exchange rate depreciation is a worsening of the trade deficit as the value of imports rises and the value of exports falls (for a given volume of exports and imports). The existence of dollar-priced contracts for some products, for instance, means that prices do not change until the contracts expire. The dollar's depreciation opens up new markets for U.S. goods, both for U.S. companies that were already exporters and for those who had not previously explored the possibility. However, it takes time for these firms to acquire the capacity and expertise necessary to increase production and meet the increased foreign demand.

Research has shown that the adjustment of export and import volumes to changes in currency values may take many months to complete, but the bulk of it should be completed in about two years. Therefore, the continued deterioration in the U.S. trade balance could be attributed to the impact of past dollar accelerations. That is, the dollar depreciation has not been in effect long enough for it to have an impact on the nation's trade balance. But this does not adequately explain current developments. The dollar decline began 18 months ago; therefore, most of the J-curve related adjustments should be, in large part, completed. Moreover, the dollar's decline since the time of the Plaza Agreement last September is a matter of U.S. policy (sometimes more explicitly stated than others), so that any questions regarding the sustainability of the initial slide should have been laid to rest by now.

The Dollar and the Trade Data

The trade-weighted measure of the dollar masks significant differences in its value *vis-a-vis* particular trading partners. For instance, since March 1985, the dollar has depreciated by 37.4 percent against the mark, but only 0.7 percent against the Canadian dollar. At the same time, it has not declined in value with respect to many currencies which are pegged to the dollar. We might, therefore, expect to see a narrowing of the trade gap with those countries whose currencies have appreciated against the dollar and no improvement in the trade balance with those whose currencies have not changed. However, this does not appear to be the case. Despite the dollar's depreciation, imports by country have generally risen significantly faster than exports since the dollar's slide began.

TABLE 1
THE DOLLAR And U.S. TRADE
(Percent)

	Dollar Decline[1]	Exports[2]	Imports[2]
Canada	-0.7%	-3.4%	+1.6%
France	-33.6	+15.9	+10.6
West Germany	-37.4	+5.0	+23.2
Italy	-31.5	-3.7	+19.9
United Kingdom	-26.4	-13.7	+17.7
Japan	-40.2	-7.2	+21.9
Total	-30.0[3]	-3.5	+11.8

(1) Percent change from March 1985 to August 9, 1986.

(2) Percent change from first quarter of 1985 to the first quarter of 1986.

(3) Trade-weighted index.

Source: The Economist, various issues.
Department of Commerce, Bureau of Economic Analysis.
Forecasting Section, U.S. Chamber of Commerce.

Nevertheless, we may have already turned the bend in the J-curve. The trade data shows that real exports of goods and services have risen by 2.3 percent since the third quarter of 1985. By region, nominal merchandise exports to Western Europe have risen by 21.8 percent since mid-1985. Merchandise exports to Japan have also improved, rising by almost 3 percent between 1985:3 and 1986:1. Even exports to Asia and Canada, whose currencies have hardly budged against the dollar, have improved.

The problem is that imports have increased at a faster pace. But this rapid growth in imports may now be tailing off. A comparison of the last three quarters (1986:2 compared to 1985:4) shows that nominal merchandise imports fell by 1.5 percent; in real terms (after accounting for inflation), they rose by only 6.1 percent. As a result, a small turnaround in net merchandise exports is now evident, but the emphasis is on the word *small*. Our bilateral merchandise trade gap with those countries whose currencies have appreciated against the dollar remains virtually unchanged.

Who's Buying...?

A reason for the continued imbalance in trade is economic stagnation abroad. During the first quarter of this year, real GNP fell in most of the major industrial countries. While the declines in economic activity in France and Italy were small, they were quite substantial in West Germany (-6.5 percent) and Japan (-2 percent). This weakness in the economies of our trading partners explains their inability to increase imports. It also explains their eagerness to export as their businesses look abroad for healthier markets. In effect, the United States continues to be the only engine of growth in the world economy.

Why are the industrial economies stagnating? One of the reasons is evident in a comparison of interest rates in West Germany, Japan and the United States. The interest rate on long-term government bonds stands at 6.1 percent in West Germany, 5 percent in Japan and 7.4 percent in the United States. Although, in nominal terms, interest rates are much higher in the United States, this is not the case in real terms. (The "real" interest rate is the nominal rate of interest minus the rate of growth of inflation.)

During the past twelve months wholesale prices *declined* by 2.8 percent in West Germany, 10.1 percent in Japan and 1.6 percent in the U.S. This means that the real interest rate on long-term government bonds stands at 8.9 percent in West Germany, 15.1 percent in Japan and 9 percent in the U.S. From this calculation, one can only conclude that real interest rates in Japan are significantly higher than those in West Germany and the U.S. However, the current *level* of interest rates is not the only relevant factor. The *path* that real rates have followed during the past year is particularly important. Comparing current real rates to what they were during the second quarter of 1985 shows that while they *fell* by 1.5 percentage points in the U.S., they *rose* by 4.7 percentage points in West Germany and 9.2 percentage points in Japan. Given the pattern of interest rates in West Germany and Japan, it is no wonder that their economies are in a slump.

TABLE 2
REAL INTEREST RATES[1]
(Percent)

	1985:2	August 9, 1986	Change[2]
United States	10.5%	9.0%	-1.5%
Japan	5.9	15.1	+9.1
West Germany	4.2	8.9	+4.7
France	2.5	7.6	+5.1
Italy	5.7	15.4	+9.7
United Kingdom	5.4	5.1	-0.3

[1] Nominal interest rate on long-term government bonds minus the twelve-month change in wholesale prices.

[2] Percentage point difference.

Source: The Economist, various issues.
Forecasting Section, U.S. Chamber of Commerce.

Both Japan and West Germany have failed to realize that they can offer much lower interest rates. The reason for not doing so is the fear that a more expansionary stance of monetary policy will fuel inflation. While this fear is well-founded, the fact that both countries are facing deflation, not inflation, seems not to be fully recognized. As of June 1986, according to IMF data, world commodity prices have fallen by 19.8 percent from their 1981 level. In addition, both countries seem to be ignoring the fact that the appreciation of their currencies will further reduce domestic inflation.

In defense of their reluctance to lower domestic interest rates, the West German authorities quibble over the correct price index to use in adjusting nominal interest rates. Instead of using consumer or wholesale prices (which include the price of imports), they hold that the implicit deflator for GNP (which does not), provides a better measure of "underlying" inflation. Thus, using the GNP deflator, they arrive at a real interest rate of about 2 percent. This argument misses the point, however. Firstly, the choice of an index of inflation which excludes falling prices is questionable. The decline in commodity prices is not a statistical quirk but an established trend. Secondly, if, in fact, the GNP deflator were the correct price index to use, then one would expect the dollar to be appreciating, not depreciating, with respect to these currencies. That is, the differential between real interest rates in the U.S. and West Germany and Japan should be increasing the attractiveness of dollar-denominated assets relative to mark- and yen-denominated assets and thus increasing the demand for dollars relative to marks and yen. This is clearly not the case.

West German officials contend that their country's economy is too small to solve the problems of the world. True, West Germany's share of total industrial country GNP is about 9 percent—a small number—but it still makes West Germany the third largest industrial economy. Both the West Germans and the Japanese also assert that the U.S. has not done its part. A large part of the blame, they claim, lies with the large U.S. budget deficit which led to high interest rates and, in turn, resulted in exchange-rate distortions. This argument has been countered many times. There is no conclusive evidence to show that large budget deficits lead to high interest rates. In fact, recent experience proves the opposite: interest rates have fallen dramatically while the deficit has reached ever higher levels.

U.S. criticism now may seem quite unfair to the West Germans and Japanese. After all, aren't their interest rates high because they cooperated with the United States' efforts at lowering the value of the dollar last September? Even admitting this fact, the point remains that almost a full year after the initial intervention, the European and Japanese economies are stagnating and prospects for the remainder of this year are doubtful. What was necessary to halt the rise in the value of the dollar was an increase in the rate of return of mark- and yen-denominated assets relative to that of dollar-denominated assets. The Japanese and the Germans chose to do this through increases in real interest rates. But the same result could have been obtained through fiscal policy; namely, a tax cut which would have improved their after-tax rate of return and growth potential, particularly in the case of West Germany.

Both the Japanese and the West Germans have so far been impervious to U.S. criticism. As a result, the Federal Reserve has just implemented its second discount rate cut without any advance agreement with Japan and West Germany. However, the impact of the continued appreciation of their currencies *vis-à-vis* the dollar on their export sectors (which are much more important as a proportion of total GNP than they are in the United States), may force them to act. When the West German and Japanese economies begin moving again, growth in the rest of the industrialized world can resume. Since Western Europe and Japan together accounted for 36.5 percent of U.S. exports of merchandise in 1985, we can then expect to see further improvements in our trade accounts.

Conclusion

The policy changes advocated in this paper; namely, stimulative fiscal and monetary policies in the developed countries, with particular emphasis on the reduction of high real interest rates in Western Europe and Japan, would go far toward increasing global economic activity and trade. These policies need not be inflationary since monetary policy is not the only policy instrument available. There is still a great deal that needs to be accomplished in the areas of tax reform and the reduction of government intrusion in the production process.

Increased economic activity in the industrial nations will firm world commodity prices. But, because technological changes have increased the supply of and reduced the demand for primary commodities in the industrial process, this increase in commodity prices will in no way resemble the inflationary spiral of the 1970s. In addition, the enormous amount of unused resources worldwide (most painfully reflected in high unemployment rates in Western Europe), will also suppress inflationary pressures.

Finally, stronger industrial country growth will have the added advantage of increasing the markets for developing country exports, thus improving their ability to finance their debt.

CHANGING PERSPECTIVE ON BANK FAILURES

by

Rajni Bonnie Ohri

Despite the drumbeat of headlines about loan defaults, large write-offs and failing banks and thrifts, the outlook for the U.S. financial system is brighter than many people think. Although 1985 was generally a prosperous year for the banking industry, not since 1933 have so many insured banks failed in a single year. Putting the problems in perspective, it should be noted that the 120 banks that failed in 1985 accounted for only 0.8 percent of all insured commercial banks. Somewhat more troubling, however, is the fact that 1,260 institutions, representing 8.5 percent of the 14,405 banks insured by the Federal Deposit Insurance Corporation (FDIC), are on its list of "problem banks." In large part, the problems faced by the U.S. banking industry are linked to regional economic factors and are centered among the smaller banks located in areas of the country where conditions in the agriculture and energy industries have deteriorated since 1981.

Bank Failures During 1985

The 1980s have been difficult years for some commercial banks and, in particular, for small banks with a focus on agriculture and energy loans. Many of the changes that are underway in the banking industry stem from changes in the underlying economy associated with volatility in the prices of key commodities. Hardest hit by this price volatility are the very companies that benefited the most from high inflation in the 1970s. The assets that once promised to increase in value indefinitely – tangibles such as petroleum, office buildings, farmland and metals – have lost luster as their prices have declined. The most troubled industries – electric utilities, energy, real estate, agriculture, mining and shipping – are all plagued by overcapacity and declining prices, born of the 1970s environment.

In particular, the farm crisis is continuing to devastate banks which are highly exposed to farmers and farm-related businesses. A substantial number of farms are facing business failure due to years of declining farm prices and land values and thus, are unable to repay their bank loans. In addition, the recent precipitous drop in oil prices has dealt a painful blow to banks which have outstanding energy loans, further straining bank loan portfolios.

About 70 percent of the nation's agricultural banks and a large share of all energy banks are located in the West North Central region (the Dakotas, Minnesota, Nebraska, Iowa, Kansas and Missouri) and the West South Central region (Oklahoma, Arkansas, Texas and Louisiana). At the same time, these regions contain nearly half of the nation's 11,800 small banks. As a result, problems in the agriculture and energy sectors have had a disproportionate impact on small banks, accounting for a substantial amount of their profitability problems.

In 1985, twenty-one states experienced bank failures. As shown by Table 1, the highest number of failures occurred in Kansas, Nebraska and Oklahoma. Texas, Iowa and Missouri followed close behind. In most of these states, farm banks continue to fail at a disproportionately high rate. A recent report issued by the FDIC concluded: "Agricultural bank failures took a sudden upturn during

TABLE 1
NUMBER OF BANK FAILURES BY STATE
1982-85

	1985	1984	1983	1982
Alabama	2	1	1	1
Alaska	–	–	–	–
Arizona	–	–	–	–
Arkansas	1	2	1	3
California	7	6	5	2
Colorado	6	2	1	–
Connecticut	–	–	–	–
Delaware	–	–	–	–
Dist. of Columbia	–	–	–	–
Florida	2	2	–	1
Georgia	–	–	–	–
Hawaii	–	–	–	–
Idaho	–	–	–	–
Illinois	2	5	6	5
Indiana	1	2	–	–
Iowa	11	3	–	2
Kansas	13	7	1	–
Kentucky	–	1	1	–
Louisiana	–	1	–	–
Maine	–	–	–	–
Maryland	–	–	–	–
Massachusetts	–	–	–	1
Michigan	–	1	–	1
Minnesota	6	4	1	1
Mississippi	–	1	–	–
Missouri	9	2	1	2
Montana	–	–	1	–
Nebraska	13	–	1	–
Nevada	–	–	1	–
New Hampshire	–	–	–	–
New Jersey	–	1	1	1
New Mexico	3	–	–	–
New York	4	–	2	4
North Carolina	–	–	–	–
North Dakota	–	–	–	–
Ohio	–	–	–	–
Oklahoma	13	5	1	3
Oregon	3	5	5	–
Pennsylvania	–	–	–	1
Puerto Rico	–	1	1	1
Rhode Island	–	–	–	–
South Carolina	–	–	–	–
South Dakota	–	1	1	–
Tennessee	5	11	12	3
Texas	12	6	3	7
Utah	1	1	–	–
Vermont	–	–	–	–
Virginia	–	–	–	1
Washington	–	–	–	1
West Virginia	–	–	–	1
Wisconsin	1	–	–	–
Wyoming	5	2	1	–
Total	120	79	48	42

Source: The American Banker, FDIC.

the second half of 1984. During the past 14 months farm banks accounted for just over 50 percent of all bank failures. Nonagricultural banks have been failing at about the same pace in 1985 as 1984, meaning that the increased number of agricultural bank failures account for nearly all of this year's higher failure rate."

Troubled Sectors

Many farm banks are finding it difficult to withstand the pressures created by adverse developments in the agricultural sector during the past several years. There are close to 4,000 banks that have 25 percent or more of their loan portfolios in farm and farm-related business loans. This represents about 28 percent of all commercial banks. Commercial banks, in general, hold $49 billion, or 24 percent, of the total farm debt outstanding. At the end of 1985, nearly 40 percent of the FDIC's *problem* commercial banks were farm banks, up from 24 percent two years earlier. Most of these banks are small, with total assets equal to only about 4 percent of all U.S. commercial bank assets.

In 1982 and 1983, there were a total of 14 agricultural bank failures. This figure almost doubled in 1984 to 25 bank failures. Last year, an additional 62 agricultural banks failed and so far this year 13 have been closed. The rapid growth in these failures has occurred primarily because of the plunge in the value of rural land, the ultimate collateral for most of the loans. Between 1981 and 1986, some farm land values declined by 60 percent or more. At the same time, most agricultural lenders have delayed foreclosures rather than throw farmers off the land, and this has contributed to further bank losses as the loans have continued to deteriorate in quality.

Although the above description paints a dreary picture of the farm economy and the agricultural finance system, there are signs that the situation will stabilize by next year (see "American Agriculture at the Crossroads," *Economic Outlook*, October, 1985). The drop in the value of the dollar and interest rates are encouraging signs. With a lower-valued dollar, U.S. agriculture exports should improve somewhat. On the positive side, farm banks have traditionally been well capitalized, offering some protection, in the short run, from loan losses. The aggregate primary capital ratio for these banks is about 10 percent, well above that of other small banks. Moreover, the FDIC reports that only about one percent of these banks have a primary capital ratio below six percent.

Mirroring the hard times of the agriculture banks, the Southwest region's banks are experiencing problem energy loans. Texas, Oklahoma and Louisiana have experienced the highest rate of energy bank failures. Many industries in these states are in the throes of a fundamental structural adjustment process as businesses that prospered with the oil boom continue to adjust to the low demand for petroleum and petroleum-related products.

There are 563 state-chartered banks that have over 25 percent of their capital invested in loans to domestic oil and gas companies, totalling $61 billion. Of these, 103 are on the FDIC's list of problem banks. In addition to the troubled state banks, there are 245 nationally-chartered banks in the same situation, with nearly $40 billion in outstanding oil and gas loans. First City Bankcorporation of Houston, with 64 banks in its network, absorbed over $260 million in bad loans last year alone, many of them to oil drilling firms. Tulsa-based BancOklahoma reports that more than 1/20th of its loans are delinquent, twice the industry average.

Under pressure from regulators and investors, many Texas and Oklahoma banks have begun following belt-tightening measures by taking substantial charges against earnings to bolster reserves for possible loan losses. Faced with write-offs exceeding $2.5 billion, or nearly 3 percent of their total loans, Texas' six major banks have sacrificed earnings, sold assets, and slashed payrolls by as much as 10 percent.

No Cause for Alarm

Admittedly, bank failures present painful problems, but they are not overwhelming. The banking system has, in fact, absorbed the 120 failures in 1985 with relative ease, showing impressive resiliency. That is because the banks themselves, with few exceptions, have been small – only 12 have had deposits of over $40 million. Moreover, the failed banks represent less than one percent of all commercial banks in the country and the total of their assets – $8 billion – accounts for three-tenths of one percent of the $2.7 trillion of the nation's banking assets. In addition, the fact that the failures have been concentrated in only a few industries has helped regulators contain the problem.

In nearly 80 percent of the failures, banking operations continued with little interruption. No insured depositors have lost money, and, in almost every case, the banks have been closed on Fridays and opened the following Monday. Perhaps the most important barometer of how the economy is absorbing these failures is the reaction of depositors, who seem unconcerned as long as their accounts are insured by the FDIC for up to $100,000.

In 87 cases, the FDIC arranged for a healthy bank to purchase some of the assets and assume the deposit liabilities of a failed bank. For instance, because of excessive lending to farmers and farm-related businesses, the Auburn Savings Bank of Auburn, Iowa, with $6.8 million in deposits, became insolvent as depressed commodity and land prices made it impossible for farmers to repay their debts. Acting along with the state banking commissioner, the FDIC shut it down, found a healthy acquiring bank – the Carroll County State Bank of Carroll, Iowa – and reopened Auburn in a few days as a branch of Carroll County. No depositors lost money and business continued as usual, but under a different name. The death of a bank was quiet, swift and almost painless.

Some observers, however, have voiced concern regarding these widespread guarantees by the federal government, noting that it tends to encourage high risk taking by the banks since failure is at the government's expense, not the banks'. As a result, regulators are pushing, and Congress is considering, a plan that would assess banks an extra insurance premium if they are engaged in risky lending practices. Moreover, legislators are attempting to extend the laws governing interstate takeovers to permit healthy banks to buy sick ones before they fail.

Conclusion

Despite all the turbulence, banks are thriving, particularly in those regions whose economies are not tied to troubled sectors. For example, in spite of the serious drought that has crippled farming in the Southeast, banks there have been booming as most states in the region have passed interstate banking laws, allowing banks wider latitude in diversifying their loan portfolios.

When considering the trouble spots of the economy, it is important to keep in mind that the basic problem faced is one of the difficult conditions of the agricultural and energy economies and not a banking problem as such. Bank regulators may provide some short-term and limited aid, but only a return to prosperity by the agriculture and energy sectors can bring a cure.

COMPARABLE WORTH: IS THE VALUE OF A JOB DETERMINED BY WHO DOES IT?

by
*Martin Lefkowitz**

Men earn more than women. The evidence is incontrovertible. In 1985, the average pay for women who worked full time was $277 per week – about 68 percent of what the average man earned in the same year. Women managers and professional and administrative workers did a tad worse during the year; their pay was less than 65 percent of that in comparable positions. This pay differential has been at approximately the same level for decades. The Equal Pay Act of 1963 and Title VII of the Civil Rights Act of 1964, both of which outlawed sex-based discrimination in jobs and pay, appear to have had virtually no effect on the differential.

But a pay differential does not prove discrimination, in spite of the fact that some court decisions appear to say that it does. For example, the courts have compared the wages of painters to those of typing pool supervisors and have ruled that by paying painters, who are primarily men, more than typing pool supervisors, who are primarily women, a government agency was discriminating against women. Unfortunately, the court did not have the common sense to say that if a teacher wanted to earn as much as a painter, she need only apply for that job. If she were not hired for a predominantly male position because of her sex; or if she were hired, say, as a painter, but paid a lower wage than her male colleagues, then she would have a legitimate sex discrimination complaint.

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What Is Comparable Worth?

Comparable worth, the concept of comparing dissimilar jobs requiring similar levels of training and responsibility, was given its greatest boost from a case involving the state of Washington. Under Governor Dan Evans, the state hired a consulting firm to determine whether male and female employees holding jobs of comparable skill levels and responsibility were receiving the same pay. The study revealed that, based on the principle of comparable worth, women, on average, were being paid 20 percent less than men. A comparison of the wages of laundry workers and truck drivers, whose jobs were estimated to be of "comparable worth," showed that the laundry workers, who were primarily women, were paid about 41 percent less than the truck drivers, who were primarily men.

As a result of this study, the focus of the debate has switched. Originally, the question was the following: Do female lawyers or supermarket clerks make more or less than men in the same jobs? Now the question being examined is one of job segregation – do women gravitate toward jobs that are traditionally "women's" jobs or is it a pattern of job discrimination that pushes them into these lower paying jobs? Further, if they do choose these jobs, is it the obligation of society to develop a pay system that will reward them equally even if the labor market dictates a lower value for these occupations?

Sex Discrimination and Market Pressures

The push behind comparable worth is based on the notion that twenty years after the passage of Title VII of the Civil Rights Act of 1964, which outlawed sex discrimination in employment, it continues in more subtle forms. The comparable worth principle is based on the belief that certain jobs, which are filled predominantly by women, have lower pay scales because of a cultural bias which depicts the work of women as having less intrinsic value than the work of men. In essence, the contention is that women, as a class, face discrimination. The fact that an employer pays wages that are on a par with those paid by other employers in the community in no way enters into consideration.

There are two factors that personnel managers consider when developing a pay system; namely, internal equity and external competitiveness. However, this is not the same system used to analyze comparable worth. The point system, which is used as the basis for analyzing comparable worth, compares those aspects of all jobs that are similar rather than comparing the jobs themselves. As such, it ignores the issue of external competitiveness. Under the point evaluation system, the emphasis is on where the job may fit in the organization and the skills and training needed for that job, rather than the level of market demand for certain job skills. For instance, although there may be a glut of airline pilots, this system would dictate that employers continue to pay pilots perhaps as much as $100,000 a year rather than the $30,000 a year that the market might dictate. The point evaluation system effectively short-circuits the role of supply and demand in the labor market – the traditional wage-setting mechanism of a free-market economy. In doing so, it seriously distorts the most valuable quality of a free market: the determination of prices (and wages) that efficiently allocates society's scarce resources to their most valuable uses.

The factors which are generally used to evaluate job comparability are knowledge, skills, mental demands, accountability, and working conditions. Such a system would conclude, therefore, that the job of a lawyer is always worth more than the job of a legal secretary, even though in the marketplace, a good legal secretary may often earn more than a mediocre lawyer.

Even proponents of the point evaluation system are critical of such a system as it is currently used. The criticism stems from the subjective nature of the evaluation process. It is argued that the system of point evaluation tends to place a greater weight on those factors that overstate the value of predominantly male jobs as opposed to predominantly female jobs. The critics assert that the elimination of wage differentials for women working in occupations that are dominated by men would not do much for the fact that women, on average, earn significantly less than men. The problem, as they see it, is that women who work in predominantly female occupations such as nurses, secretaries, grade school teachers, typing pool supervisors, and clerks are making less money than men in "comparable" occupations, mainly because of cultural bias.

The New York Times recently reported on specific examples of wage disparities between male and female occupations with similar point rating systems. The report was based on various studies of the concept of comparable worth. For instance, the report found that in Illinois, licensed practical nurses, a female-dominated occupation, are paid about $1,298 per month, less than one-half the monthly pay for electricians, even though both jobs were deemed similar in terms of the comparable worth principle. Table 1 shows other jobs with similar point evaluations but significantly lower pay scales based on the predominant gender of those usually occupying such positions.

The job matches on Table 1 are but a few of the jobs determined to be comparable in worth based upon studies in the states of Washington, Illinois, and Minnesota. The irony of these comparisons is that, while they appear to be scientific in nature, they are based on a very high degree of judgment. If the person performing the job evaluation overstates the value of certain skills, the result can be lopsided. The best example of this is the contention of women's groups that too much emphasis is placed on physical strength in certain job evaluations. However, even the perfect system for developing internal job equity would still not deal with the second essential element in a pay system; namely, external competitiveness.

TABLE 1
COMPARABLE OCCUPATIONS AND WAGE DISPARITIES BY GENDER

Female		Male	
Occupation	**Monthly Salary**	**Occupation**	**Monthly Salary**
Typing Pool Secretary	$1,373	Painter	$1,707
Legal Secretary	$ 665	Senior Carpenter	$1,040
Secretary	$1,122	Maintenance Carpenter	$1,707

Source: The New York Times, January 1, 1984.

The Bill for Equity

The goal of those who advocate pay comparability is to bring average salaries for women up to the level of men's salaries. However, little or no attention is paid to the costs involved. For instance, the nation's wage bill in 1982 would have been increased by $190 billion, or 12.1 percent, if salaries for so-called "female occupations," had been brought up to par with salaries paid in comparable male-dominated positions. The option of achieving comparability by cutting wages for predominantly male jobs is not available since employers are specifically forbidden from lowering the wages of any employee in order to comply with pay comparability laws.

Another problem that arises from mandated pay comparability is how to raise the market value of predominantly female occupations. Do we tell all employers of nurses, for instance, that they have hitherto been paying these persons a wage that is too low, even though these were determined by the marketplace? This places the government in the position of dictating wage rates to the marketplace. In essence, it creates a perverse form of wage controls that tells employers to pay higher wages for certain jobs. This, unfortunately, is not quite as preposterous as it appears at first glance since the federal government already sets minimum wage levels under the Fair Labor Standards Act (FLSA). However, mandated pay comparability would be more job-specific than the FLSA dictates and would, therefore, require a system of record-keeping akin to that necessary for administering wage and price controls.

Along with the problems of record-keeping and wage determination is that of pay ranges, which for any particular position, vary widely. For instance, a particular individual occupying a job as a secretary sometimes earns twice as much as another person having a similar position in another firm. We would, therefore, have to devise a pay system similar to union or government pay scales that push for equality in pay rather than allowing for differences due to merit of the incumbents in their specific positions.

What the Numbers Don't Tell You

The Department of Labor should clarify the statistics to ensure that the data released is not misused to sensationalize many of the preconceived notions of the most radical critics of American business. The release of data should include clarifications that will ensure that it will not be misused and/or abused. Most of the statistics now being issued are raw data and fail to include caveats explaining the reasons for pay differentials.

While the pay of men and women appears to be significantly different in many cases, even when both sexes occupy the same positions, there is very little evidence that there is a widespread pattern of discrimination on the part of American business. This is supported by the fact that, with 50 million women currently in the labor force, there are less than twenty thousand complaints filed under the provisions of the Equal Pay Act of 1963. Given the litigious nature of our society, this suggests that the preponderance of employers are acting in accordance with the Equal Pay Act of 1963 and the Civil Rights Act of 1964 which require that men and women be paid equal wages.

The following are some of the statistical problems related to the issue of equal pay and which the data issuing agencies should specify more clearly:

Some of the comparative wage data includes both part-time and full-time workers. This tends to overstate the differential between male and female wages. Women are nearly two-and-one-half times more likely than men to work part time. Less than 12 percent of the men in the labor force work part-time schedules, while about 30 percent of the women are part-time workers. This difference in hours worked is contributing to the pay differential. A comparison of the data for full-time workers only, shows less of a sex-based difference in pay. Moreover, analysis of full-time workers in the same occupations shows that the pay is even more comparable.

Even when both men and women work full time, women tend to work fewer hours than men. For example, the U.S. Department of Labor defines full-time work as 35 or more hours of work per week. Statistics show that women who work full time are more than three times as likely as men to work less than 40 hours per week. Men, on the other hand, are two-and-one-half times more likely than women to work over 40 hours per week. However, this hours differential is not reflected in the median wage data that places all persons who work more than 35 hours per week in the full-time category. It would, therefore, be appropriate for the Labor Department to note this discrepancy in hours worked in the full-time workers' category.

The average man will spend about 42 percent more of his lifetime in the labor force than the average woman. The chances are still about 50/50 that a woman will drop out of the labor force for a period of time, particularly while she has small children. Statistics show that 55 percent of women with children below the age of six, and 40 percent of those with children between the ages of six and 17, are not in the labor force. Interruptions in labor force participation have a significant impact upon pay as knowledge becomes obsolete at a rapid pace in today's dynamic economy. Periods of absence from the labor force, therefore, result in a depreciation of job skills. As a consequence, the jobs available to those reentering the work force are generally entry level (lower paying) positions.

Another factor that contributes to pay differentials is tenure in a specific job with a specific employer. Because of the importance of seniority in determining wages, two persons performing the same job who have been employed for different time periods by the same employer will generally receive different pay, even if they show the same degree of job proficiency. For example, the government's pay scale for new employees is 75 percent of what high seniority employees receive for doing the same job. The average tenure of men with the same employer is over 50 percent greater than it is for women. And, in the mid-career ages of 45 to 54, when pay tends to be highest, the average tenure for men is 13.4 years, nearly twice the 6.9 years average for women of that same age group. The Labor Department should note these differences in tenure when the data is issued.

Women have inordinate representation in jobs and professions that tend to have more flexible work schedules. It appears that women employees are willing to forgo greater pay for more flexibility. For example, women comprise over 80 percent of all elementary school teachers, an occupation with a work year of about 180 days (most occupations have a work year of about 240 days). Other occupations which employ a preponderance of women, such as nurses and waitresses, may not have shorter workweeks but do have more flexible schedules than most occupations.

Women tend to be less geographically mobile than men. This limits their ability to seek the best opportunities and the highest salaries. For example, during the last recession, there were large numbers of unemployed auto workers, predominantly male, who migrated to Texas and Louisiana in search of high paying jobs in the oil fields, rather than accept lower paying jobs available in Michigan. In contrast, women tend to sacrifice their own career opportunities by staying with their families and are willing to move only in response to better job opportunities for their husbands. A comparative study of the earnings of single women and single men indicates that they have similar employment characteristics and that, therefore, they earn virtually identical wages.

A study conducted by Jacob Mincer and Soloman Polacheck indicated that women spend less time than men on productivity-enhancing education and training. This is another factor explaining the existence of pay differentials between men and women. A related factor, which also contributes to some of the observed differential in pay, is the number of years of college attendance. While there are about as many women attending college today as there are men, the historical difference in college attendance is significant. Of all persons in the labor force over the age of 35, men are 50 percent more likely than women to have attended four or more years of college. The Department of Labor data for specific occupational groups does not reflect differences in training and experience.

Thus, the statistical evidence indicates that through choice and chance many women have been concentrated in occupations that pay lower wages. The solution to the problem of pay equity is to ensure that all persons have equal access to all economic opportunities, a goal that was the basis of the Civil Rights Act. It is absurd to even suggest that the marketplace, comprised of more than five million firms, has conspired to hold the wages of women below that of men. The rulings of the courts, until recently, have essentially expressed the view that the law takes note of discrimination against people and not against jobs.

Do Firms Adhere to Equal Pay Principle?

Table 2 shows the results of a study of female/male pay ratios. This study showed that, when taken on a job-to-job/company-to-company basis, women are paid about the same as men. The large disparity in male/female pay is a result of females being perceived as less likely to rise to higher levels within their respective organizations. For example, while 46 percent of the entry level accounting positions are held by women, they occupy only five percent of the top level positions. Therefore, when all women accountants are compared to all male accountants, it is this disparity in job levels that results in women accountants making less money than men. Large numbers of ple, the U.S. Department of Labor defines full-time work as 35 or more hours of work per week. Statistics show that women who work full time are more than three times as likely as men to work less than 40 hours per week. Men, on the other hand, are two-and-one-half times more likely than women to work over 40 hours per week. However, this hours differential is not reflected in the median wage data that places all persons who work more than 35 hours per week in the full-time category. It would, therefore, be appropriate for the Labor Department to note this discrepancy in hours worked in the full-time workers' category.

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TABLE 2
FEMALE-MALE PAY AND EMPLOYMENT RATIOS
1981

Occupational Work Level	Average Monthly Pay	Female-Male Pay Ratio	Female Share of Total Employment
Accountant 1	$1377	99	46%
Accountant 2	1679	98	34
Accountant 3	1962	95	19
Accountant 4	2402	90	11
Accountant 5	2928	90	5
Accountants (All levels)	1642	71	40
Attorney 1	1873	103	28
Attorney 2	2338	99	24
Attorney 3	3031	95	13
Attorney 4	3738	94	9
Attorneys (All levels)	2364	71	22
Chemist 1	1508	96	38
Chemist 2	1757	94	29
Chemist 3	2120	93	15
Chemist 4	2567	92	10
Chemist (All levels)	2025	70	21

Note: The data for all members of an occupation are annual averages based on unpublished tabulations from the *Current Population Survey* conducted by the U.S. Department of Labor. Data for occupations by level are based on statistics from the Bureau of Labor Statistics 1981 *National Survey of Professional, Administrative Technical and Clerical Pay* (PATC Survey), which covers white-collar employees in medium and large firms.

women have recently entered previously male-dominated professions such as law and accounting, but have not yet been in these professions long enough to rise to higher levels of pay and responsibility. However, pay eventually equalizes as women attain greater tenure and advance to higher level positions.

Table 2 indicates that while there is a pay differential between men and women in the same profession, when taken on a job-to-job basis within organizations, there is virtually no pay differential between the two sexes. The reason for the apparent pay differential appears to be based on the different work levels of men and women related to advancement within occupational groups, rather than pay differences within narrowly defined pay categories.

Conclusion

The data indicate that men and women are receiving equal pay for equal work, but that more men are employed in higher levels of many professional occupations than are women. This difference is, in part, directly attributable to the fact that women have been employed in certain professions, such as accounting and law, more recently than men.

TRENDS IN COMMERCE NOTES ON TABLE II AUGUST/SEPTEMBER 1986

by
*Martin Lefkowitz**

Gross National Product (GNP) – Benchmark revisions of the national income and product accounts in July showed that Gross National Product – the total value of goods and services produced in the economy – grew at a 2.8 percent rate in the last two years instead of the previously reported 2.0 percent. Revised data for the second quarter indicate that GNP grew at a 0.6 percent annual rate. However, the economy is not as weak as the GNP data would indicate. Final sales, after adjusting for inflation, grew at a vibrant 3.8 percent rate in the second quarter but the lower rate of inventory build-up, which

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added $45 billion to first quarter GNP, subtracted $28 billion from second quarter output. Consumer spending grew at a 6.5 percent rate in the second quarter. Despite a 2.3 percent drop in nonresidential fixed investment, the producers' durable equipment component rose by 19.9 percent. Residential investment remains strong, rising by 13.5 percent in the second quarter. However, the second quarter revision reflected a continuing deterioration in the nation's trade deficit, with exports declining by 5.6 percent while imports rose by 16.5 percent.

The Services Sector– Employment in service sector establishments increased by 363,000 jobs in July and is now 2.6 million jobs above its year-ago level. This compares with an increase of 26,000 jobs in the goods-producing sector during July. Over 99 percent of the job growth in the economy during the past year has been in services industries.

Consumer purchases of services increased by 0.9 percent in June. Major domestic airlines reported that revenue passenger miles flown, that is, the number of passengers multiplied by the miles flown by each passenger, reached 25.7 billion in July, an increase of approximately 12.3 percent from its year-ago level. Over the past seven months, domestic passenger travel has increased 10.2 percent and available seat miles were up 13.0 percent. International passenger traffic, experienced a 6.3 percent decline in July compared to July of last year.

Money Supply– The nation's money supply–as measured by M1, currency in circulation plus demand deposits–increased by 1.2 percent in June and was 12.8 percent above its year-ago level. This is considerably above the Fed's target range of three to eight percent.

Employment– The civilian unemployment rate fell from 7.1 percent of the labor force in June to 6.9 percent in July. Employment in service producing industries grew by 363,000 jobs in July, with much of the gain concentrated in business and health services, retail trade, finance, insurance and real estate. The number of nonagricultural payroll jobs–as measured by the monthly survey of business establishments–increased by 390,000 in July after falling 54,000 in June due to several work strikes. After adjusting for workers returning after strikes, however, the July gain was 240,000. Civilian employment–as measured by the monthly survey of households–increased by 210,000 persons and now stands at 109.9 million jobs (after seasonal adjustment).

Consumer Price Index– The Consumer Price Index for all urban consumers (CPI-U) was unchanged in July following a 0.5 percent rise in June. The index for July was 1.6 percent higher than July of last year. While each of the energy components declined, the index for energy commodities dropped 6.3 percent. Excluding energy, the CPI-U rose 0.5 percentage points in July, largely as the result of increases in the indexes for food and shelter.

The Producer Price Index for finished goods fell by 0.4 percent in July, following a sharp decline during the first 4 months of 1986, before turning up in May, and showing no increase in June. The decline in the index can be attributed to the 11.9 percent fall in energy prices. The intermediate goods index fell by 0.7 percent, also the result of the decline in energy prices. However, the index for intermediate goods, excluding energy, edged up 0.2 percent. After dropping 1.1 percent in June, the crude goods index rose by 1.2 percent in July. Food prices rose 1.9 percent in July after being unchanged in June, and prices other than food and energy rose by 0.3 percent.

Housing Starts– Privately owned housing units were started at a seasonally adjusted annual rate of 1,818,000 units in July, a decrease of 1.8 percent from the June level. July housing starts were 9 percent above the July 1985 level. The July drop reflected a continued decline in apartment construction which many are attributing to the uncertainty over tax reform legislation. Building permits, an indicator of future activity in the home building industry, were down 2 percent for the month.

Corporate Profits and Cash Flow– Corporate profits have been sluggish for the past year. While profits increased by 8.5 percent between the second quarter of 1985 and the second quarter of 1986, they remained below their fourth quarter level of 1985. Economic profits, which takes into account economic depreciation and adjusts for changes in inventory valuation, were up 6.2 percent for the quarter from their year-ago level. Net corporate cash flow, which includes depreciation allowances, increased nearly 3.4 percent over that same period, indicating a strong cash position in the corporate sector.

Industrial Production– Industrial production fell 0.1 percent in July, marking the fifth decline of the index which has occurred this year. Much of the decrease can be attributed to weakness in capital spending and the lack of inventory build-up. Oil and gas well drilling continued its downward trend in July. Manufacturing output was unchanged in July after falling 0.5 percent in June; production by utilities fell by 0.2 percent and mining output dropped by 0.4 percent.

The capacity utilization rate in manufacturing declined 0.2 percentage points in July to 78.2 percent, down from 78.9 percent of capacity in June. The decline was attributable to a significant drop in auto production and in instruments, petroleum products, and rubber and plastic products. Over the past six months, the overall rate has fallen 2.6 percentage points. The capacity utilization rate in nondurable manufacturing was 84.0 percent of capacity, little changed from recent months.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Jun/86	241.4	241.2	239.2	0.0	0.9
Gross National Product ($B)	II/86	4,179.8	4,149.2	3,965.0	0.7	5.4
Gross National Product (82$B)	II/86	3,661.5	3,665.9	3,567.6	0.1	2.6
Money Supply (M1) ($B)	Jun/86	666.7	658.7	590.9	1.2	12.8
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Jul/86	2,758.3	2,761.8	2,591.2	−0.1	6.4
Personal Consumption Expenditures (82$B)	Jun/86	2,424.9	2,410.3	2,316.5	0.6	4.6
Disposable Personal Income ($B)	Jul/86	2,990.2	2,976.7	2,828.0	0.4	5.7
Disposable Personal Income (82$)	Jun/86	2,613.6	2,628.0	2,528.0	−0.5	3.3
Personal Savings Rate (%)	Jul/86	4.2	4.0	5.3	0.2[b]	−1.1[b]
Civilian Employment (millions)	Jul/86	109.9	108.6	107.0	0.1[c]	1.6[c]
Civilian Unemployment Rate (%)	Jul/86	6.9	7.1	7.3	0.2[b]	0.4[b]
Average Hourly Earnings	Jul/86	$8.73	$8.75	$8.55	−0.2	2.1
Consumer Price Index (All Urban, 67 = 100) [a]	Jul/86	328.0	327.9	322.8	0.0	1.6
Purchasing Power of the Dollar (67 = $1.00) [a]	Jun/86	0.305	0.306	0.310	−0.3	−1.6
Prime Interest Rate (%) August 13, 1986		8.0	8.5	9.5	−0.5[b]	−1.5[b]
Retail Sales ($B)	Jul/86	118.7	118.6	114.6	0.1	3.6
SERVICES SECTOR						
Employment in Services (Millions)	Jul/86	75.4	75.0	72.8	0.5	3.6
Consumer Purchases of Service ($B)	Jun/86	1,439.9	1,426.5	1,331.8	0.9	8.1
Consumer Purchases of Service (82$B)	May/86	1,171.8	1,170.6	1,112.0	0.1	3.1
Domestic Revenue Passenger Mileage Flown Major Airlines (Billions) [a]	Jul/86	25.7	24.0	22.9	7.0	12.3
BUSINESS PROFITS AND OUTPUT						
Corporate Profits and Cash Flow ($B)						
Before Tax	II/86	231.9	224.3	213.8	3.3	8.5
Profits Tax Liability	II/86	91.2	89.1	87.1	2.3	4.7
Tax Liability as a Percent of Profits	II/86	39.3	39.7	40.7	−0.4[b]	−3.8[b]
After Tax	II/86	140.8	135.2	126.7	4.1	11.1
Net Cash Flow	II/86	383.4	380.9	370.8	0.6	3.4
Industrial Production (77 = 100)	Jul/86	124.1	124.2	124.1	−0.1	0.0
Capacity Utilization Rate (Mfg.) (%)	Jul/86	78.5	78.7	80.1	−0.2[b]	−1.6
New Housing Starts (thou. units)	Jul/86	1,818.0	1,852.0	1,673.0	−1.8	8.6
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	II/86	169.1	168.8	165.9	0.1	1.4
Unit Nonlabor Costs (nonfarm) (77 = 100)	II/86	164.8	163.9	160.8	0.5	2.5
Producer Price Indices (67 = 100) [d]						
Crude Materials	Jul/86	278.0	274.9	303.8	1.1	−8.4
Intermediate Goods	Jul/86	305.0	307.1	318.6	−0.6	−4.2
Finished Goods	Jul/86	288.0	288.9	294.8	−0.3	−2.3
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100)	Jun/86	622.3	626.5	583.1	−0.7	6.7
Federal Gov't Gross Debt Outstanding ($B) [a]	May/86	2,035.6	2,012.6	1,758.3	1.1	15.8
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	II/86	375.6	374.8	370.0	0.2	1.5
Imports of Goods & Services ($B)	II/86	472.0	468.5	447.1	0.7	5.6
Balance on Goods & Services ($B)	II/86	−96.4	−93.7	77.1	2.9	25.0
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	Jun/86	178.6	178.1	167.7	0.3	6.4

NOTE: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted.

[b] Percentage point difference.

[c] January data is a new series that is not comparable to previous data.

[d] Index number not seasonally adjusted, percent change seasonally adjusted.

Productivity – Nonfarm business productivity increased at a seasonally adjusted annual rate of 1.6 percent in the second quarter of 1986. This was about half the 3.3 percent growth rate reported in first quarter. Output rose by 1.3 percent while hours worked declined 0.3 percent. This was the first decline in hours worked since the fourth quarter of 1982 when they fell at a 3.4 percent rate. Manufacturing productivity rose at a 1.9 percent annual rate in the second quarter, and output declined by 1.5 percent, while hours dropped by 3.4 percent. This was also the first quarterly decline in manufacturing output since the fourth quarter of 1982.

Interest Rates – The prime interest rate currently stands at 8.0 percent, 1.5 percentage points below its year-ago level. Three- and six-month Treasury bill rates were both near 5.6 percent in mid-August, about 0.2 percent below their level of a month earlier. Thirty-year Treasury bonds which had traded at about 7.5 percent at the end of July, fell to 7.2 percent in mid-August, about the same level as the beginning of July.

Federal Spending – The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, declined to 622 in June (1967 = 100), a 0.7 percent decrease from the previous month and 6.7 percent below the level of June 1985. Federal receipts for the first nine months of fiscal year 1986 increased by 4.5 percent, while expenditures for the same period rose by 4.2 percent. The federal deficit for the first nine months of fiscal year 1986 was $166.8 billion compared to $162.0 billion during the same period in fiscal year 1985.

Personal Savings – The personal savings rate was 4.2 percent of after-tax income in July, higher than the 4.0 percent savings rate in June, and 5.3 percent savings rate in July of 1985.

Retail Sales – Retail sales rose by 0.1 percent in July, following a revised 0.1 percent drop in June. The increase occurred despite the decline in gasoline sales which dropped by 2.6 and apparel store sales which fell by 0.2 percent. The July increase in retail activity was mainly attributed to the rise in sales by major department and grocery stores.

Trade Deficit – On a goods and services basis, the trade deficit in the second quarter of 1986 was $96.4 billion, slightly more than the $93.7 billion reported in the first quarter. The continued increase in the trade deficit occurred despite lower oil prices and a significant drop in the value of the dollar. The manufacturing trade deficit continued to grow, reaching the year's high of $12.7 billion in June on increases in sales of foreign cars, textiles and clothing. Imports, including oil, totaled $33.2 billion, a 4.4 percent increase over the six-month average. Exports reached a high for the year of $19.1 billion.

What's Ahead – The composite index of leading indicators, designed to predict future movements in aggregate economic activity, rose 0.3 percent in June, following a downward revision for May. Six of the 11 indicators were up, three were down, and two remained unchanged. The contributors to the June increase in leading indicators include new orders for consumer goods and industrial materials, contracts and orders for plant and equipment, building permits, money supply, stock prices and change in sensitive materials prices. The three negative contributors were changes in credit outstanding, vendor performance, and average workweek. Over the past six months, the index has risen by 5.7 percent.

HOW PRODUCTS FARE

Exports that increased in past year as dollar fell –	
Agricultural machinery	+ 19%
Plastics	+ 19%
Paperboard	+ 11%
Organic chemicals	+ 11%
Pharmaceuticals	+ 10%
Heating, cooling equipment	+ 10%
Pulp, waste paper	+ 8%
Exports that declined –	
Corn	– 62%
Iron, steel	– 21%
Wheat	– 16%
Aircraft	– 9%
Instruments	– 5%
Where trade gap widened –	
Automobiles	by 36%
Motorcycles, bicyles	by 30%
Textiles	by 21%
Telecommunications gear	by 5%
Lumber	by 3%

Source: *U.S. News and World Report*, August 11, 1986.

SUMMER YOUTH EMPLOYMENT – 1986

In its annual report on summer youth employment, the Bureau of Labor Statistics reported that the number of 16 to 24 year olds in the labor force increased by 3.5 million between April and July of 1986, about the same as last year, but less than the increases of 4.2 and 3.9 million in the summers of 1983 and 1984, respectively. During July 1986, the youth labor force totaled 26.1 million, 500,000 less than the July 1985 level.